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Ofgem Annual Report

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Ofgem Annual Report

2005-2006

Report of the Gas and Electricity Markets Authority for the period 1 April 2005 to 31 March 2006 to the Secretary of State for Trade and Industry.

The document comprises a report made under Section 5(1) of the Utilities Act 2000. It also sets out information on Impact Assessments as required by Section 5A(9) of the Utilities Act 2000, as introduced by Section 6 of the Sustainable Energy Act 2003.

Office of Gas and Electricity Markets

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

We operate under the direction and governance of the Gas and Electricity Markets Authority which determines strategy and decides on major policy issues.

Our 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.

Ofgem London

9 Millbank, London SW1P 3GE
Tel: 020 7901 7000

Ofgem Scotland

Regent Court, 70 West Regent Street,
Glasgow G2 2QZ
Tel: 0141 331 6000

www.ofgem.gov.uk

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Foreword by the Chairman

2005-2006 saw challenging times for us, as regulator, for domestic and business consumers, for Government and for the energy industry as a whole, both here and in Europe.



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Customer prices continued to rise, concerns about the future of security of supply refused to abate, the Government announced a full-scale Energy Review and the European Commission found the political will to issue its interim sectoral review report, thereby demonstrating its determination to tackle head-on the reluctance among some member states to open up energy markets to full competition.

As we become more dependent on imported gas, for Ofgem this year has been one of facilitation, with much of our work carried out against the backdrop of continuing price rises and the worries about future security of supply.

I want to highlight in particular our work with large energy users, helping to improve market information and transparency so that businesses can engage in the market more effectively to stave off some of the worst effects of spiralling wholesale gas prices.

In our work in the Union, most notably with our fellow regulators, I believe we were pivotal in pushing the European Commission to take forward its inquiry into European energy market competition in a robust and positive manner. I personally welcomed its decision to undertake 'dawn raids' on a number of companies under EU anti-trust laws, a clear demonstration that it has the necessary political will to act.

During the year, my Presidency of the Council of European Energy Regulators (CEER) and Chairmanship of the European Regulators' advisory Group for Electricity and Gas (ERGEG) and my membership of the Commission's High Level Group on Competitiveness, Energy and the Environment, contributed to Ofgem's central role within the EU in helping to drive the full liberalisation of energy markets. These roles gave Ofgem the opportunity to add significantly to the formal advice provided to the Commission, to develop and share best regulatory practice and bring forward key policy proposals.

Our submission in response to the Government's Energy Review was well-considered and provided Government with ideas and suggestions on several aspects of energy policy, notably in the area of sustainability.

Those worst affected by rising fuel bills have been vulnerable customers. We have a key role to play in helping tackle fuel poverty and our Social Action Strategy launched during the year built on previous initiatives and will

encourage a more co-ordinated approach to tackling this blight. In our submission we specifically pointed out that Government should focus its resources on improving incomes and housing to address the plight of the fuel poor.

This year Ofgem also began the enormous task of setting price controls for the gas and electricity transmission companies, as well as for the new gas distribution network owners. It is important to ensure we get the right balance in these price controls, between protecting customers' interests – our first priority – and other concerns, such as ensuring there is adequate investment in the networks to cope with the growth of renewable generation. We also need to allow room for the companies to reinforce and expand existing networks as well as replace ageing assets. Our task as regulator is to ensure that cost effective innovative decisions are made to allow companies to deliver appropriate levels of investment.

Better regulation has been our watchword during the year and I congratulate all those who have worked to beat Ofgem's own RPI-X targets to allow 10 per cent of our budget to be handed back to licence payers.

I would like to pay tribute both to the executives on the team, so effectively led by Alistair Buchanan, and to my fellow non-executives on the Authority. They have given generously of their time and expertise to help Ofgem meet the challenges of last year.

Alistair Buchanan and I now enter our fourth year at the Ofgem helm. There have been many changes, in organisation as well as policy, but the staff in Ofgem have responded magnificently to them. Innovative solutions, long hours, expertise and good humour have been the hallmark of their performance. Their commitment has been crucial, as it will be in the coming years.

Sir John Moggy
Chairman

2 The Gas and Electricity Markets Authority

The Gas and Electricity Markets Authority has the ultimate responsibility for all that Ofgem does.

It determines strategy and decides on major policy issues.

Membership

Sir John Mogg
Chairman



David Gray
Executive



Sarah Harrison
Executive



Sir Keith Stuart
Non-executive



Dr Robin Bidwell
Non-executive



Miriam Greenwood
Non-executive



Jayne Scott
Non-executive



Professor Len Waverman
Non-executive



Alistair Buchanan
Chief Executive



Judith Hanratty
Non-executive



Steve Smith
Executive



John Wybrew
Non-executive



Introduction by the Chief Executive

The 'F' in Ofgem should this year be translated as 'facilitator'. Following our focus on developing as a listening organisation in 2004-2005, last year we focused on our facilitation role.



This was both timely and relevant in a year of sharply rising prices, which have been felt by all customers but particularly by vulnerable consumers and major energy users, and at a time of increasing carbon emissions.

This facilitation role encompassed :

- the energysmart campaign to promote the switch and save message for domestic consumers. Switching has risen to record levels as a response to the Autumn 2005 price increases.
- facilitating the creation of an Ombudsman scheme, through the Energy Retail Association and energywatch.
- assisting industry and commerce to react to the harsh pricing and supply conditions, by leading a series of seminars and workshops across the country. An effort recognised by Sir Digby Jones in a letter of thanks from the CBI to Ofgem in December 2005.
- working, wherever possible, to encourage better targeting of measures to help vulnerable consumers and those in fuel poverty, for example the new 'find and fix' drive which we have advocated.
- leading the debate on key energy issues of the day through the 'Powering the Energy Debate' seminar series. Last year's meetings had themes on fuel poverty and energy efficiency and the next two debates scheduled for 2006 are on Microgeneration and Europe.

In general Ofgem has sought to facilitate debate on energy policy across all its functions through regular evidence to parliamentary and other enquiries (including the Trade and Industry Select Committee, Environmental Audit Committee, Public Accounts Committee, Royal Society of Edinburgh and House of Lords Committees), speeches, and media events. We also had our first open Authority meeting during the last year, and made our Board minutes available to all consumers. We see the facilitation role as a key part of our regulatory toolkit and we will continue this work for consumers in the year ahead, in particular as we approach another tight winter.

Faced with the pressure on prices Ofgem has been keen to provide the consumer with confidence that it will take independent decisions, that are in the consumer's interest. Our Markets Division concluded its probes of both the

North Sea and the Sean gas field. These two reviews provided confidence that the high prices are not being caused by unacceptable behaviour or contracts. We reinforced this monitoring role last winter when we made it clear that 'use it or lose it' provisions would be rigorously enforced at the Isle of Grain LNG terminal.

Where Ofgem's arm failed to reach we did the next best thing for the GB consumer – to assist in any way that we could the EU Commission in its review of the gas and electricity markets. Much coverage has been given to the positive statements made by Commissioner Kroes in February, in which she supported liberalised markets and condemned anti-competitive behaviour. This has been followed up by dawn raids across Europe at some major power companies.

Ofgem has also continued its embrace of sustainability. Of our five main recommendations to the Government's Energy review three were sustainability driven: a new carbon trading scheme, an annual sustainability report, and the facilitation (the 'f' word again!) of renewables power to be connected to the electricity network. Closer to home the Authority has set up a standing committee on sustainability (chaired by Robin Bidwell), has inserted an environmental step into its Impact Assessment (IA) process, and has maintained the ISO14001 standard.

Our reputation for delivering complex projects was enhanced in the year with the successful completion of the desegregation of the local gas network companies. Sir John Bourn of the National Audit Office (NAO) commented 'Ofgem displayed a sound understanding of the complexities of the sales, and the project team showed drive and determination to ensure that necessary regulatory tasks were completed.'

As a business Ofgem continued to challenge itself and espouse the credo of better regulation :

- Ofgem beat its RPI-X targets and as such will hand back to licence payers nearly 10 per cent of its allowed budget.
- a new look to our documents was rolled out in 2005-2006 to good feedback.
- plaudits were given to our processes from Cranfield business school (for IAs), from the Treasury's Keegan review (for our finance functions), and from the Better Regulation Task Force.

▶ 10 Introduction by the Chief Executive

- in the spirit of the Hampton report, we passed the metering function to the National Weights and Measures Laboratory.
- we are pushing ahead with our extensive review of the supply licence conditions, with the aim of significantly cutting the barriers to market entry and participation.

Apart from handing back £2.9m to licence payers, Ofgem also recorded a sound year on meeting its operational targets. Our Corporate Affairs team beat their targets and achieved 78 per cent clearance levels of modifications and 94 per cent on new licences. Our corporate deliverables target was 75 per cent which was comfortably beaten (87 per cent) and Chiene and Tait, our auditors, rated our progress as 'very good' in implementing internal audit recommendations. Our Freedom of Information record was also a leader amongst the public sector, as recorded in the Financial Times league tables in December 2005.

This winter will be my fourth at Ofgem and it promises to be a challenging one for the organisation. In addition to handling the consequences of high prices and security of supply concerns, Ofgem is also managing a unique treble of price reviews (the five year transmission networks price review, the one year gas distribution networks extension price review, and the initial phases of the full five year gas distribution price review). Ofgem is also looking forward to working with the Sustainable Development Commission in its first ever 'in depth review' which will report before Christmas 2006. Finally, Ofgem will respond positively to the Government's plans for the energy sector, in areas which are of relevance to us.

The ability to handle these tasks rests with the quality of the team at Ofgem, and given their track record in recent years I am confident that we can continue to serve consumers extremely effectively. The scope and scale of the work has changed markedly over the last few years. Today's Ofgem employees need to be able to understand a wide range of topics including global LNG markets, the latest policy and legal changes in the EU, and sustainability issues. It makes for an interesting and varied career, and perhaps it was no surprise therefore that this year we had a successful launch of our first ever graduate recruitment scheme, and we achieved a major recruitment campaign for our Glasgow office.

My thanks go to the Ofgem team.



Alistair Buchanan
Chief Executive



Creating and sustaining competition

4

Key achievements 2005-2006

Wholesale

- Pushed for EU competition investigation into European energy markets
- Introduced reforms to gas market to provide more user-friendly information to businesses
- Approved proposals to improve the information that offshore producers and gas importers provide the gas market

Retail

- Worked to unlock the potential of smart metering and remove barriers to microgeneration
- Oversaw introduction of new arrangements under which customers can receive compensation from suppliers for poor billing service
- Continued work on reviewing supply licences in line with better regulation principles

Introduction

Competition in the wholesale and retail energy markets has brought considerable benefits to consumers since it was introduced. Ofgem remains committed to the principle that competitive markets provide the best protection for consumers. Effective competition helps keep pressure on costs and promotes more diversity in gas and electricity supplies and a greater choice of tariffs and services for customers.

In 2005-2006, after many years of low prices, energy bills in Britain began to rise for both domestic and business customers. Despite this, household bills are still among the most competitive in Europe. While business customers have been particularly affected by rising wholesale gas prices, they have still paid less for their energy during the last 14 years than most of their European counterparts.

Our work during this period continued to focus on monitoring market developments to identify and tackle any barriers to competition as well as ensure that prices reflect genuine supply and demand factors and are not the result of market abuse or other distortions. We have also sought to provide more information to the market to help customers and industry take better informed trading decisions.

Wholesale

More than half of domestic gas and electricity bills are made up of wholesale energy costs. These same costs make up three quarters of business customers' bills. Because of this, our priority is to help ensure the wholesale gas and electricity markets remain competitive.

Much of our work during the year was focused on the reasons behind unprecedented rises in wholesale gas prices which had an adverse knock-on effect on wholesale

electricity prices, business energy bills – and on domestic energy bills which saw average rises of 34 per cent in electricity and 48 per cent in gas.

Gas

National Grid's winter outlook report in May, and subsequent update in October, showed that energy supplies could be maintained even in a Siberian-style, one in 50 winter (see 'Helping protect the security of Britain's energy supplies', page 21). However, 2005-2006 saw challenges to the market and customers due to lower gas supplies than in previous years as Britain changed more quickly than expected from a country which is self-sufficient in gas to one which is now a net importer of gas.

While the decline in North Sea gas reserves was largely anticipated, the rate of decline has been much quicker than forecast. This, alongside high oil prices feeding through to Britain via the rest of Europe, meant that businesses began to face high gas prices. It also meant that there was a need for large gas users to reduce their demand when supplies were at their tightest – known as 'demand-side response'.

That is why we gave a special focus to helping business customers engage more effectively in the market. We introduced reforms to the gas market which provided businesses with more user-friendly information enhancing their ability to take more informed purchasing decisions and to reduce gas demand on a commercial basis.

These included:

- a new National Grid website providing customers with better information on demand and supply
- new 'Gas Balancing Alerts' which give larger gas users advance warning of National Grid's need for demand-side response (see 'Helping to protect the security of Britain's energy supplies', page 21)
- Ofgem-hosted events throughout the country. These brought market participants together to give large customers more information to help their energy buying decisions for the winter, and

- in October 2005, we participated in a large UK customer-led delegation to the EU Competition Directorate in Brussels.

In May 2006, we also approved a proposal by consumer watchdog, energywatch, to allow suppliers, traders and customers access to more information about gas supplies into the UK.

This was a difficult decision and one where we had to balance the customers' desire for more information against the concerns raised by many gas producers and importers. We considered that the decision to approve this proposal was appropriate and these developments will be implemented ahead of winter 2006-2007.

During the year, we also pushed the European Commission to look into the state of competition in the continental gas market. We are committed to influencing European policy aimed at achieving full market liberalisation throughout Europe and backed the sectoral review being undertaken by the Commission, the initial findings of which were published in February 2006 (see 'A leading voice in Europe', page 24).

Winter 2006-2007

Because of the continuing uncertainty over gas supplies and the potential for further gas price rises, Ofgem pledged to continue its efforts to ensure that the market has accurate and timely information about offshore gas supplies, gas storage in Europe and beyond and the progress of major infrastructure projects.

National Grid's initial outlook report regarding gas and electricity supplies for the winter was published in May 2006. This report highlighted the fact that gas supplies may again be tight during the winter of 2006-2007 where commercial demand-side response from gas-fired power stations and large industry will again play a crucial role.

As part of this information-sharing, we have been holding a series of meetings at very senior levels with European companies that import gas into Britain to encourage them to provide National Grid with more accurate information about the levels of gas imports we can expect from continental Europe this winter. We are also continuing to work closely with European companies to understand the interconnector flows observed last winter ahead of winter 2006-2007.

The Energy Review

Affordable, sustainable and reliable energy supplies are the key objectives of the Government's energy policy and these objectives have come sharply into focus as energy prices have risen and concerns about carbon emissions have increased.

Also, events during the year caused many to question whether or not markets are the best way of delivering energy policy. That is why we welcomed the Government's Energy Review, published in January, as the ideal opportunity to tackle these concerns and help build further confidence in the markets (see also 'Regulating network monopolies', page 17, 'Helping to tackle fuel poverty', page 31, and 'Helping to protect the environment', page 27).

Our response to the Energy Review reaffirmed our position that the combination of competitive markets and effective, independent network regulation remain the best way of meeting the energy challenges of the future.

Key recommendations in our response included:

- offering to provide long-term scenario analysis for networks and markets, to improve customer awareness and inform company investment planning
- providing suggestions to address systemic risk and fuel poverty concerns
- ideas for funded long-term carbon contracts to work alongside the EU Emissions Trading Scheme (EU ETS) while agreement is reached over its future, and
- calling on Government to provide clarity on nuclear licensing, planning and waste, gas quality and new technologies.

We believe that markets, while not perfect, are nevertheless the best way to secure affordable, sustainable and secure energy supplies for consumers.

National Grid System Operator incentives

During the year, Ofgem put forward proposals for an incentive scheme on National Grid Electricity Transmission (NGET) as system operator. NGET operates the high-voltage network and balances the electricity system to

ensure that supply meets demand. We set an incentive scheme covering these external costs to encourage NGET to carry out its balancing more efficiently.

In February 2006, we set out two targets for NGET's external costs which were rejected by NGET in March. Ofgem's Authority decided in May 2006 not to refer NGET at this stage to the Competition Commission, believing that the interests of consumers would be best served by Ofgem using existing licence conditions to regulate NGET's external costs for 2006-2007.

We take our duty to monitor compliance very seriously and if there is evidence that NGET is incurring costs inefficiently, we would take appropriate enforcement action against the company. We hope to be able to put in place new incentive arrangements for 2007-2008.

Cash-out arrangements

An important part of the wholesale markets arrangements are the rules and incentives in place to encourage market participants to take actions to balance the supply and demand of energy. Where participants have failed to balance their positions, the system operator must take action by buying and selling energy to bring either the electricity or gas system back into balance.

Cash-out arrangements provide incentives on market participants to balance themselves by imposing the costs that system operators incur back to those parties that caused the imbalance in the first place.

During 2005-2006, Ofgem chaired the cash-out review group to look at potential defects in the current arrangements. In December 2006, this group provided Ofgem with analysis and findings to take forward during 2006-2007.

We also approved a proposal aimed at better reflecting the costs NGET faces as electricity system operator when resolving energy imbalances. This is due to be implemented in November 2006 and will help provide enhanced incentives on participants to balance their positions.

Retail markets

After many years of low prices, energy bills in Britain are rising, mainly in response to rising prices for gas and coal. Despite this, British domestic consumers still enjoy some of the lowest energy prices in Europe.

We still think that competition is the best way to protect the interests of consumers. It has given customers much greater freedom of choice over who supplies their power and how they pay for it. Just over five years since the energy markets were opened fully to competition, about 50 per cent of all customers have changed their gas or electricity supplier. This has led to more competitive pricing, new products and better customer service.

In taking forward work on retail markets, we will continue to promote competition while at the same time having regard to our duties relating to sustainable development, the environment and vulnerable customers. The following areas of work were priorities for us during the year.

Metering

Ofgem's policy on metering is based on our view that competition is the best form of protection for consumers. But, because of the many concerns about lack of innovation in this area and the strong interest in the potential environmental and social benefits, we have been carrying out a review of the effectiveness of current arrangements and of the costs and benefits of smart metering.

In February 2006, we launched the review and invited responses from industry and consumer bodies and pledged to work with Government, energy suppliers, meter manufacturers, electricity and gas network operators and consumer groups to see how best to unlock the potential of smart metering.

Workshops and events were held during the year and, in June, we challenged energy suppliers to bring meters into the 21st century after we announced an industry-wide programme to break down the barriers to smart metering. Ofgem will form an industry-wide group to set standards for smart meters and remove the regulatory barriers suppliers face in installing smart meters in customers' homes.

Microgeneration

Ofgem is looking to dismantle the barriers that prevent more people from generating electricity in their own homes. Microgeneration units, such as solar panels and gas-fired heating boilers that also generate electricity and small wind turbines, can generate enough electricity to power electrical equipment in the home and allow customers to sell any surpluses back to their supplier.

In March 2006, we set up an industry forum to strengthen further the work going on in the sector addressing the barriers preventing the growth of this type of generation and to develop and implement solutions to remove these barriers. The Microgeneration Forum will focus on ensuring that high level policy is consistent and coherent with regard to technology and its benefits for customers.

Allowing customers to generate their own electricity will not only help them save money on their bills but also help reduce carbon dioxide emissions.

Customer disputes

While we believe there is scope to rely even more on competition rather than regulation, we recognise that energy is an essential service and this makes the energy markets a little different from other normal commodity or service industry markets.

One main area of attention for us during the year was the concern expressed by customers about suppliers' performance in the way they bill their customers which resulted in a 'super complaint' by consumer body, energywatch. During our investigation, we found no systemic failure of industry billing arrangements, although we did find that a relatively small number of customers suffered real harm when companies made billing mistakes. Ofgem told suppliers in July 2005 that they had a year to take three key steps to improve their billing processes:

- the creation of an industry Ombudsman scheme to award compensation to resolve disputes quickly,
- a ban on charging customers for the energy they used if their supplier fails to bill them for two years (this will reduce to one year in 2007), and
- a requirement on suppliers to review domestic customer contract terms to ensure compliance with consumer rights legislation.

These measures have now been met and we expect this package to deliver improved customer service.

Supply licence review

Our commitment to better regulation is reflected in our approach to key policy areas, not least the supply licence review which looks to remove licence conditions that are no longer necessary in a competitive market and to ensure that where licence conditions remain, they are targeted and proportionate. The review is due to be completed in 2008.

As part of this wide-ranging, bottom-up review, we consulted separately on the implications for vulnerable customers in order to ensure the widest possible consideration of views (see 'Helping to tackle fuel poverty', page 31).

A strand of the review was to consider the obligations on suppliers to accede and comply with the range of industry codes. We concluded that this work had implications for all companies who are party to these codes and all licences which include these obligations. A new industry codes compliance review project is now underway.

In July 2006, we published initial policy proposals for the supply licence review which contain plans to cut down red tape by 50 per cent while protecting customers better with clearer, easier to understand customer protection.

Industrial and commercial customers

During the year, Ofgem worked with suppliers and customer groups to identify key concerns regarding competition in the industrial and commercial energy market. From this, a series of initiatives have begun focusing on issues such as data quality.

Supplier failure

During the year, a number of smaller energy suppliers exited the energy market and, for the first time, Ofgem had to invoke 'supplier of last resort' procedures to ensure that customers of these companies continued to receive energy supplies.

▶ 16 Creating and sustaining competition

Monitoring and enforcement

Ofgem continued regular market surveillance. September 2005 saw the launch of our new domestic market report which analyses the state of competition in the domestic retail market. This is important to understanding the drivers for, and barriers to, competition and help provide confidence to consumers. The latest report published in July 2006 shows switching is at its highest level for four years.

Investigations and enforcement have an important role to play to ensure the market functions effectively and to provide consumer confidence (see Appendix III).

In May 2006, we issued a Statement of Objections against National Grid as part of a Competition Act investigation into the provision of domestic gas meters. This is the first such action we have taken under the Act.

An investigation into whether EDF Energy plc's conduct in withdrawing the provision of electricity meter reading and related services from electricity suppliers not affiliated to EDF amounts to an infringement of the Competition Act is ongoing.

Regulating network monopolies

5

Key achievements 2005-2006

- Work commenced on the gas and electricity transmission price control review
- Gas networks sale given consent to proceed
- Consultation on first ever gas distribution price control review launched
- Work commenced on regulatory framework for offshore electricity transmission



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Introduction

Where competition is not practicable, or is insufficiently well developed, Ofgem protects consumers' interests by regulating through price controls and incentive schemes. This helps ensure that consumers receive value for money and a secure and reliable service. These schemes apply to the monopoly businesses which run the pipes and wires networks that transport gas and electricity to homes and businesses.

Gas and electricity networks are facing a time of change. New patterns of energy supply, such as imported gas and renewable generation, together with moves to develop distributed energy all have potentially major implications for investment in the networks.

Ofgem will continue to develop incentives for long-term investment to respond to new demands of users, as well as measures to improve quality of service and provide better value for money for customers.

Electricity and gas transmission

Britain's gas and electricity transmission networks face an unprecedented challenge to support the growth of renewable generation, connect new gas import and storage projects and replace network equipment as it wears out.

To allow us to assess this challenge, we decided in 2004 to align the timing of the gas and electricity transmission price controls across the whole of Great Britain, which will lead to new price controls taking effect from April 2007.

The consultation process for these price controls began in July 2005 when we sought views on the key issues surrounding the review. This was followed by two more consultation papers in December 2005 and March 2006 which demonstrated our desire to implement best practice in terms of the consultation process.

A key theme for the transmission price control is flexibility and how to provide funding, when it is needed, for investment triggered by new supplies of gas and electricity potentially connecting to the networks. The growth in renewable generation and the shift towards gas imports are important issues in this context.

The review must also provide the right structure of financial incentives to encourage the transmission companies to respond efficiently to meet the needs of network users and consumers. This requires good quality information and financial commitments from network users, to allow the transmission companies to deliver the right investment at the right time.

Another key theme is how we ensure that our transmission networks receive sufficient renewal investment to preserve the high levels of system performance and reliability.

Since the end of the financial year, we have set out our Initial Proposals for these price controls. In these we set out baseline allowances for investment in the gas and electricity transmission networks amounting to more than £4 billion over the next five years. Actual investment, including investment triggered by new requirements of network users, may be significantly higher and our proposals may result in almost double the amount of investment in the networks that was allowed in the previous five-year price controls.

Gas distribution

In May 2005, Ofgem's Authority gave its final consent for National Grid Transco – now National Grid Gas (NGG) – to sell four of its gas distribution networks.

Ofgem's role in considering approval of the sale was to ensure that customers' interests would be protected if the sale went ahead. As part of our considerations, we analysed the impact of the sale and estimated that the potential net benefits to consumers, arising from our ability to take advantage of effective comparison between separately owned and managed gas distribution network operators, could be in the order of £225 million.

We also welcomed a report by the National Audit Office (NAO) on the sale. Sir John Bourn, Comptroller and Auditor General, said: "At a time when consumers are facing rising gas prices, I am encouraged to see that the

changes to the gas industry arising from the sale of the networks have potential benefits for consumers. Ofgem has done well so far. I will be looking to Ofgem to maintain its commitment to ensuring that the potential benefits are realised."

This commitment began in December 2005 when we set out our objectives, together with our proposed timetable and approach, for the review of price controls for the gas distribution networks, which will take effect from April 2008.

This review is the first time that Ofgem will set a price control for gas distribution on its own. It provides an opportunity to focus on the activities of the gas distribution businesses and explore what customers want from these businesses so that we can better protect their interests.

We will be drawing on the experience gained during the electricity distribution price control review for 2005-2010 which the industry agreed was a substantial improvement on previous reviews in terms of transparency and process.

Gas offtake reform

A key condition of consent for the sale of four of NGG's gas distribution networks related to a commitment to reform of the transmission access regime covering the points of the network where gas is drawn from the transmission network and delivered to power stations, large users and the gas distribution networks.

In June 2005, Ofgem's Authority decided to postpone these gas offtake reform proposals until 2007 – a decision prompted by concerns expressed to us by the industry that consultation on the proposals needed more time.

This meant that we had to develop a set of transitional offtake arrangements as well as beginning the process of consulting on the longer-term reforms through the transmission price control process. These reforms are intended to give NGG signals about when and where to invest and to provide a level playing field for all those wanting access to the networks.

Transmission charging

The new electricity market arrangements, which were introduced in April 2005, meant that a system of charging arrangements for the high-voltage transmission networks had to be introduced to cover the whole of Great Britain. Ofgem's Authority approved National Grid's proposals for new charging arrangements with the proviso that the regime is reviewed within two years and improved if necessary.

In February 2005, ScottishPower sought a Judicial Review of the Authority's decision and in October 2005, the High Court dismissed ScottishPower's legal challenge on all counts.

In welcoming the Court's decision, Ofgem Chairman, Sir John Mogg, pointed out that the new charges had already helped reduce the impact of electricity price rises for both domestic and business customers in Scotland – and the overall impact of the new charges on Scottish generation was broadly neutral.

Electricity distribution

In June 2005, Ofgem gave the go-ahead for the first 'Registered Power Zone' to test innovative ways of connecting more renewable generators to the distribution network and help the Government meet its climate change targets (see 'Helping to protect the environment', page 27). A second scheme was announced in May 2006.

We also conducted a lessons-learned exercise on the Distribution Price Control Review (DPCR) completed during 2004-2005 and our conclusions are being taken onboard in the current price control reviews for transmission and gas distribution.

During the year, we completed the first annual cost reporting exercise regarding the electricity distribution companies. This was a key commitment from the DPCR and includes, for the first time, publication of annual Regulatory Asset Value (RAV) figures.

In February 2006, we published a joint discussion paper with the water regulator, Ofwat, on Financing Networks to take forward the debate on this cross-sectoral issue.

▶ 20 Regulating network monopolies

DCUSA

The publication of Ofgem's conclusions in November 2005, and the subsequent agreement to a Collective Licence Modification, have enabled the distribution network commercial arrangements to be consolidated into a single agreement – the Distribution Connection and Use of System Agreement (DCUSA). The DCUSA will create a more transparent set of commercial terms that are also able to respond effectively to changes such as those needed for distributed generation.

Offshore electricity transmission

The first steps towards establishing a regulatory regime for offshore electricity transmission were taken forward by the Department of Trade and Industry (DTI) and Ofgem in July 2005. Following this consultation, the Secretary of State for Trade and Industry decided in March 2006 that offshore networks would be subject to price controls rather than be built on a 'merchant' basis.

Offshore networks are important as they will transfer electricity from offshore renewable generating stations – such as wind farms and potential technologies that harness wave and tidal resource – to the onshore network.

In April 2006, we published a scoping document which set out the issues which need to be addressed in creating a suitable regulatory framework and we are now working with the DTI on the details of the arrangements with a view to implementing them in 2008.

The Energy Review

Ofgem's core work is the regulation of networks and in the recent electricity distribution networks price review and in the current transmission price reviews, we seek to ensure that the regulatory arrangements are 'future-proof'.

That is why, in our response to the Energy Review, we recommended that we work with the network operators to publish longer-term scenario analysis which will help inform the investment decisions of network users and allow us to set price control decisions in a longer term context.

This is especially important as significant new build in gas and electricity generation infrastructure is likely to need substantial new investment in networks. The networks also face technical challenges such as dealing with intermittent forms of generation and the potentially significant growth of distributed energy, including smaller-scale microgeneration.

Monitoring and enforcement

In October 2005, Ofgem accepted a series of commitments offered by SP Manweb to improve the way it provides its electricity connections services.

Under the Competition Act 1998, Ofgem investigated allegations that SP Manweb was providing a better service to its affiliate connections business, Core, than to independent connections providers, which could have undermined their ability to compete effectively.

This was the first time that any sector regulator has accepted commitments offered by a company under the Competition Act. SP Manweb will now tackle the competition concerns we identified.



Helping protect the security of Britain's energy supplies

6

Key achievements 2005-2006

- Ofgem-chaired group helped develop new gas balancing alerts
- Secured improvements to access to Isle of Grain LNG terminal
- Network performance improved significantly
- Facilitated development of new National Grid website to help market
- Facilitated wider release of GB storage information to the market on a daily basis
- Key participant in developing and testing energy emergency arrangements

Introduction

The security of energy supplies is central to everything that Ofgem does. Our approach, shared by Government, is to rely on effective competition in wholesale and retail energy markets, and on network monopolies having the right incentives to invest (see 'Regulating network monopolies', page 17).

This has served British consumers well by achieving reliable supplies at a reasonable cost.

We also monitor the market rules and, with Government, provide timely information about future developments and trends. This allows industry to respond effectively to meet security of supply needs. We also take action to remove any barriers which stop this happening.

Winter 2005-2006

During winter 2005-2006, the gas market experienced challenging conditions with the loss of 10 per cent of gas supplies on days of high demand after the emergency closure of the Rough gas storage facility in February 2006. The market also saw erratic flows of gas through the interconnector pipeline between Britain and continental Europe.

Gas supplies were lower than expected at the beginning of winter so Ofgem took action to provide the market with analysis to explain this.

We also saw for the first time demand-side response, mostly from gas-fired power stations and large industrial and commercial customers in response to the unprecedented high gas prices.

Flows from the interconnector were not always in line with prices. We estimated that this could have added about £1 billion to British wholesale gas prices and if repeated during winter 2006-2007, it could add a further £3 billion to prices.

We worked with the Department of Trade and Industry (DTI) – as regulator of the offshore industry – to understand beach supply behaviour and concluded that when beach gas supplies did not meet expectations over the November cold snap, it was due to genuine short-term production problems.

Also, we were concerned about how unused capacity at the Isle of Grain Liquefied Natural Gas (LNG) terminal was being offered to third parties – the so-called 'use it or lose it' arrangements. National Grid Grain and BP and Sonatrach – the two main users of the terminal – confirmed that they would put in place new arrangements to make it easier for third parties to use any available capacity at the terminal, maximising use of this important gas import facility.

In liaison with industry and customers at the Ofgem-chaired Demand-side Working Group, we introduced Gas Balancing Alerts which are designed to provide a signal to the market that more gas is needed to keep the system in balance.

This new mechanism was used for the first time on 13 March 2006 in response to high gas demand and lower than expected supplies. The market responded with large users – particularly gas-fired power stations – reducing their demand and suppliers drawing on gas in short and medium range storage. This meant that the system was kept in balance, with supply meeting demand.

Network performance

A report issued by Ofgem in December 2005 showed that the performance of Britain's local electricity networks has improved significantly since we introduced quality of service incentives in 2002.

During this period, the average number of power cuts fell by 16 per cent and the length of power cuts also fell by the same percentage. The report showed that network operators have responded to the challenge we set for them in 2002 and that we have strengthened the incentives on the networks to restore customers promptly and efficiently.

Monitoring security of supply

Both the Government and Ofgem have a role to monitor and inform the market about key developments in future security of energy supplies.

During the year, Ofgem continued to participate in the Joint Energy Security of Supply (JESS) group which was established to monitor developments in gas and electricity markets and to help participants plan investment decisions.

We also contributed to the Department of Trade and Industry's (DTI) annual report to Parliament on security of supply and monitored and reported to market participants on security of supplies, as required by EU directives.

Emergency arrangements

During the year, Ofgem played an integral role in helping the Government and industry develop contingency plans to ensure that the energy industry is prepared in the event of an emergency.

We were the driving force behind the creation of the new Energy Emergencies Executive (E3) which supervises emergency planning arrangements and is chaired by the Department of Trade and Industry (DTI).

Emergency planning arrangements have been tested during the year through various simulated exercises involving industry, regulator, Government and consumer groups. This included a major review and test programme for Black Start – the plans for recovery from the very unlikely event of a national electricity shutdown. The project completed its work in May 2006 and learning points are being progressed.

We also held two seminars to help customers and market participants better understand the emergency arrangements, as well as approving industry code changes to help improve the commercial incentives on gas shippers to avoid a gas deficit emergency.

A leading voice in Europe

Key achievements 2005-2006

- Sir John Mogg took over CEER Presidency and ERGEG Chairmanship
- Provided expert staff to assist EU competition inquiry
- Led the development of regional gas and electricity initiatives across Europe



Introduction

The competitiveness of British energy markets, and the interests of British energy customers, are affected increasingly by what happens in other European gas and electricity markets. This was particularly evident during winter 2005-2006.

That is why Ofgem works with the European Commission, other national regulators and competition authorities to promote full and effective liberalisation of European energy markets and to help shape future regulation and legislation.

A key focus during the year was trying to make sure that gas can be transported and priced across Europe in a fair and non-discriminatory way. This means making sure there are no barriers to liberalisation and that all markets operate effectively and efficiently. This focus continues.

Working across Europe

Ofgem Chairman, Sir John Mogg, is Chairman of the European Commission's advisory group of regulators (ERGEG) and President of the Council of European Energy Regulators (CEER), as well as a member, on a personal basis, of the European Commission's high-level group on Competitiveness, Energy and the Environment. CEER and ERGEG develop and share best regulatory practice and provide formal advice to the Commission on the development of EU regulatory policy.

Throughout the year, Ofgem contributed extensively to both CEER and ERGEG and has taken a lead role in developing policy proposals for submission to the Commission's energy and competition directorates and developing EU regulators' views on key issues. Ofgem maintained regular contact with industry on European developments, including through participation in the cross-industry group organised by the Association of Electricity Producers (AEP).

Key issues in 2005-2006

DG Competition inquiry

In February 2006, we welcomed the Commission's initial proposals following an inquiry by its Competition Directorate into the European gas and electricity markets. The inquiry was prompted by concerns over the unprecedented rises in wholesale prices (see 'Creating and sustaining competition', page 11), barriers to entry and limited customer choice.

The Commission identified the key barriers to effective competition emerging and committed to come forward with solutions towards the end of the year to tackle the problems they had identified.

We loaned experts to help the gas inquiry and also provided a number of analytical papers from CEER/ERGEG and on a bilateral basis.

In May, we welcomed the exercise of competition powers when the Commission carried out unannounced raids on gas firms suspected of violating EU anti-trust rules. Chairman Sir John Mogg said that the raids proved that the Commission now has the political will to open up European energy markets.

Green Paper

The Commission published a Green Paper on energy in March 2006 which presented initial findings from a transport and energy directorate inquiry into the liberalisation process and noted that much more needed to be done by Member States to ensure that consumers receive the full benefits from the opening up of markets.

CEER/ERGEG provided key information and analysis – and will continue to do so – as detailed reviews of each country are carried out and a final report is published late in 2006. The first report is expected to be on energy strategy for Europe. Ofgem is leading the work in developing a CEER response to the Green Paper. These reviews will include aspects such as implementation of legislation, access to networks, effective regulation and unbundling of network companies.

Regional initiatives

Ofgem has a leading role within ERGEG in the development of electricity and gas regional initiatives. These are crucial to the liberalisation agenda and set out the key issues that will need to be resolved if the benefits from a single competitive market are to be realised.

The Electricity Regional Initiative was launched in February 2006 and the gas initiative in April 2006.

Environment

Ofgem plays a key role in European environmental issues such as emissions trading, energy efficiency and renewable energy. We currently chair the CEER Environment Task Force and represented CEER at the first European Commission Sustainable Energy Forum in Amsterdam in October (see 'Helping to protect the environment', page 27).

Regulatory expertise

Ofgem's technical expertise allows us to offer advice and briefing papers on key relevant issues in Europe. During the year, this has included providing advice to the Commission's research directorate on the provision of support for energy projects and working with the Commission and other regulators on the regulatory framework needed for the development of efficient wholesale and retail market structures.

We also act as the vice-chair of an EU Technology Platform, a cross-sector body with senior representation from European industry, regulators and academia which is addressing the challenges facing Europe's electricity networks for the future and is identifying innovative, efficient and effective solutions.

Helping to protect the environment

8

Key achievements 2005-2006

- Over 10.8 million Renewables Obligation Certificates (ROCs) issued during 2004-2005, compared with just over 7.5 million in 2003-2004
- Under EEC, suppliers installed, or provided, energy efficiency measures which would result in energy savings of 86.8 TWh
- Major investment in transmission and distribution networks to facilitate renewable generation
- Progress made towards unlocking the potential of smart metering and microgeneration



Introduction

Ofgem's overall goal is to assist the gas and electricity markets and industry to achieve environmental improvements as efficiently as possible to ensure that no unnecessary costs are borne by customers.

We encourage the development of market mechanisms to value and reduce carbon. We also promote energy efficiency and administer a range of Government environmental schemes to develop renewables and Combined Heat and Power (CHP) and install energy efficiency measures in the home.

The Government has set a target for a 20 per cent reduction in carbon emissions by 2010, on top of commitments made under the Kyoto agreement.

About a quarter of the UK's emissions of greenhouse gases are caused by electricity generation and these have been increasing over the past three years. However, the energy sector has contributed significantly to the fall in emissions since 1990, reducing the amount of carbon emitted by almost 12 per cent.

Environmental policy

Ofgem has established a framework to ensure that policies which have a significant environmental impact are consistent with our statutory objectives and duties, including placing a value on carbon dioxide emissions where appropriate.

To help support this, we established a Sustainable Development Committee, chaired by Authority member Robin Bidwell, which will inform our work on sustainable development and act as an advisory committee to our Authority.

During the year, we looked at other areas of policy that could have an impact on the environment. These included the obligation on suppliers to promote energy efficiency and the incentives of network businesses to reduce energy losses and connect renewable generation.

Other areas of policy which may have significant impacts on the environment included the:

- price control reviews (see 'Regulating network monopolies', page 17) which mean us looking at the treatment of losses and shrinkage, network investment for renewable generation and the effect of investment on visual amenities
- advising the DTI on offshore electricity transmission regulation, and
- work on innovative metering and removing the barriers to the development of microgeneration (see 'Creating and sustaining competition', page 11).

Influencing the wider environmental debate

During the year, Ofgem took part in the wider debate on energy and environmental policy in a number of ways, including in Europe (see 'A leading voice in Europe', page 24). This included:

- inputting into the process of establishing the UK's National Allocation Plan for the second phase of the EU Emissions Trading Scheme (EU ETS) and advising the DTI and Department for the Environment, Food and Rural Affairs (Defra)
- contributing to key Government reviews including the Climate Change Programme and the Economics of Climate Change Review (The Stern Review)
- contributing to the European Commission's review on key directives affecting energy and the environment
- playing a major part in the Council of European Energy Regulators (CEER) work programme on environmental matters, and
- contributing to the Government's joint working group on energy and the environment and its sustainable energy policy network.

Energy Review

Significant progress has been made in starting to tackle carbon dioxide emissions through the EU Emissions Trading Scheme (EU ETS). We support the scheme strongly and will be advising the Government and European Commission as

they consider subsequent phases and review its effectiveness.

As part of our response to the Government's Energy Review (see also 'Creating and sustaining competition', page 11, 'Regulating network monopolies', page 17, and 'Helping to tackle fuel poverty', page 31), we suggested how a carbon contracts scheme could be used to help meet domestic carbon reduction targets while the next phases of the EU ETS are being considered. These could be funded by revenues from auctioning allowances under the EU ETS scheme.

Power zones

In June 2005, we gave the go-ahead for the first 'power zone' to connect more renewable generators to the distribution network (see 'Regulating monopoly networks', page 17).

Central Networks was the first network operator to have part of its network designated as a Registered Power Zone (RPZ) by Ofgem. RPZ status is given to networks which employ innovative approaches to connect new generators to their system. It provides an enhanced financial return to the network company for their successful management of the risks associated with innovation.

Scottish and Southern Energy was the second operator to have part of its network designated as an RPZ.

Microgeneration

Allowing customers to generate their own electricity will not only help them save money on their bills but also help reduce carbon dioxide emissions. As outlined in 'Creating and sustaining competition', page 11, Ofgem is working to tackle the barriers which prevent people from generating their own electricity. Working with industry, such as through the Microgeneration Forum, which Ofgem set up in March 2006, and through the Electricity Networks Strategy Group will help us remove impediments to this type of energy.

Environmental programmes

Ofgem administers, on behalf of Government, important elements of its Climate Change Programme:

Renewables Obligation

The Renewables Obligation and Renewables Obligation (Scotland), which came into force in April 2002, require licensed electricity suppliers to source at least part of their electricity from renewable generation.

The target for companies to reach started at three per cent in 2002-2003 and reaches 15.4 per cent in 2015-2016. The target continues at this level until 2027. The target for 2005-2006 was 5.5 per cent and is 6.7 per cent for 2006-2007.

Ofgem also administers the Renewables Obligation in Northern Ireland, via an agency agreement. This came into force in 2005 and the target for electricity supply companies in Northern Ireland was 2.5 per cent in 2005-2006 and is 2.6 per cent on 2006-2007. This reaches 6.3 per cent in 2012-2013 and extends at this level until 2027.

In an overview of the third year of the Renewables Obligation published in February 2006, Ofgem reported that a total of 788 generating stations were accredited, with 179 of these being accredited in the third year. Over 10.8 million Renewables Obligation Certificates (ROCs) were issued during 2004-2005, compared with just over 7.5 million in 2003-2004. Also, over £153m was redistributed to GB suppliers in the third period. This compares to just under £175m in the second period.

Climate Change Levy

Ofgem also continued to administer the Climate Change Levy (CCL) exemption for renewables. 2005-2006 was the fifth year of the CCL exemption and nearly 17 million Renewables Levy Exemption Certificates (LECs) were issued.

Since April 2003, the exemption from CCL for direct supplies of 'good quality' Combined Heat and Power (CHP) generated electricity was extended to include indirect supplies, ie those supplies exported to the grid. We issued nearly 23 million CHP LECs in 2005-2006 to complying CHP schemes, and to date we have issued around 75 million CHP LECs to these stations.

▶ 30 Helping to protect the environment

REGOs

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.

Energy Efficiency Commitment

Ofgem continued to administer, on behalf of the Department for Environment, Food and Rural Affairs (Defra), the Energy Efficiency Commitment (EEC) programme (see 'Helping to tackle fuel poverty', page 31). The EEC obliges domestic electricity and gas suppliers to deliver energy savings from domestic consumers. Half of the energy savings must come from priority customers who receive benefits or certain tax credits.

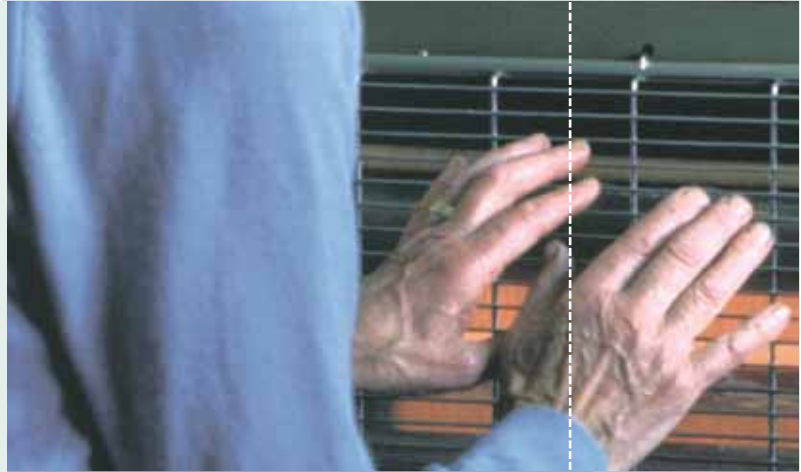
The third annual EEC report was published in August 2005 and showed that suppliers had installed, or provided, energy efficiency measures which would result in an energy saving of 86.8 TWh, or 140 per cent of the total target of 62 TWh.

The environment and consumers

In April 2005, we consulted on a revised set of guidelines for supplying electricity from renewable sources. Green supply deals are offered by most energy suppliers to customers who want to use electricity from renewables.

We issued guidance to electricity suppliers on how to comply with their licence obligation to inform customers of the fuels used to generate their electricity and their environmental impact.

We have been working with suppliers on exploring ways of improving the information that their customers receive on their energy consumption to help them manage demand. The potential environmental benefits of better consumer information from innovative meters has been one of the main drivers of our work in this area (see 'Creating and sustaining competition', page 11).



Helping to tackle fuel poverty

9

Key achievements 2005-2006

- Launched new five-year Social Action Strategy
- Updated and developed protection for vulnerable customers through the supply licence review
- Range of company corporate social responsibility initiatives and social tariffs continued to develop

Introduction

Ofgem has a key role to play in helping to tackle fuel poverty. We have a specific duty to have regard to the interests of vulnerable customers, those who are disabled or chronically sick, older people and those living on low incomes or in rural areas.

Low incomes, poor housing stock and energy costs are the main causes of fuel poverty. The number of households in fuel poverty has reduced in the last decade, largely because of improving incomes and falling fuel prices. However, double digit price rises seen during the year are having an adverse affect on fuel poverty.

By promoting competitive energy markets, regulating network monopolies and promoting more efficient use of energy, Ofgem helps keep up the pressure on energy costs. We encourage best industry practice in reducing debt and disconnection and development of special tariffs, and promote special services for vulnerable customers.

Social Action Strategy

Launching Ofgem's new five-year Social Action Strategy in June 2005, Chairman Sir John Mogg said that rising household energy prices were threatening progress in cutting the number of fuel poor households and that a more joined-up approach was needed to help meet this challenge.

Our new strategy built on initiatives to encourage a much more co-ordinated approach to tackling this blight and involves Government, industry, consumer and voluntary organisations.

During the year, we set up a Social Action Strategy Review Group to examine particular issues affecting vulnerable energy consumers and facilitate discussion of solutions. A number of issues have been covered in the year: financial inclusion, better targeting and identification, the role of the Priority Services Register and benefits health checks. We will continue to drive these debates forward and support any initiatives which emerge.

Research published at the same time as the Strategy showed that there had been a significant increase during the last two years in companies' Corporate Social Responsibility (CSR) initiatives, with more than £110 million being spent during 2004-2005, much of it focused on alleviating fuel poverty. These are welcomed as is the major initiative undertaken by industry in the year to establish the Home Heat Helpline.

Ofgem's Sustainable Development Committee (see 'Helping to protect the environment', page 27) will also look at how our sustainability duties can be used to help vulnerable customers.

Supply licence review

The interests of vulnerable customers are of particular concern in Ofgem's review of company supply licences (see 'Creating and sustaining competition', page 11). We recognise that special protection for vulnerable customers will continue to be needed but we are committed to reviewing the requirements to ensure they are proportionate and do not distort competition.

We have worked closely with consumer groups representing vulnerable customers in developing these proposals to ensure that the appropriate balance is struck.

Energy efficiency

In August 2005, our report on the first three years of the Energy Efficiency Commitment (EEC) (see 'Helping to protect the environment', page 27) showed that about 10 million British households, six million of which are on low incomes, benefited from energy savings measures.

To help tackle fuel poverty, as well as reduce carbon emissions, suppliers have provided under the scheme measures such as cavity wall insulation, energy-efficient boilers and energy saving light bulbs.

We believe that improving household energy efficiency is the most sustainable way of tackling fuel poverty especially at a time of rising fuel bills. Low income customers have benefited by around £175 million a year as energy suppliers worked with social housing providers and charities to target help at those most in need.

Distribution network reward scheme

In March 2006, we urged local electricity networks to enter an Ofgem scheme to recognise and reward best practice in meeting and exceeding their obligations to help vulnerable customers.

A total of £1 million will be available across all network areas for each year of the current distribution price control. With the help of an independent expert panel, Ofgem will recognise the initiatives and steps taken by the companies to serve their customers. The aim of the scheme, by identifying and encouraging best practice, is to improve standards across all distribution companies.

The Energy Review

In our response to the Energy Review, we identified further steps that we believe the Government should take to ensure that everyone's home is adequately and affordably heated.

Energy prices are unlikely to fall back to the levels of the 1990s, given world energy trends and the investment that is needed in new sustainable energy supplies and in renewing and expanding the gas and electricity networks.

More resources are needed to address the problem of fuel poverty and these resources should come from Government and be focused on improving incomes and housing, rather than on social tariffs. Further thought needs to be given to what is the best way to deliver that help and ensure that it is targeted where it is needed most.

Key achievements 2005-2006

- Ofgem now prioritises all work under an RPI-3 per cent cost control regime which is set to cut costs by £8.2 million over five years
- 'Project Paperless' - Phase I delivered to improve quality of documents and reduce their volume
- First Simplification Plan produced
- 87 per cent of deliverables met and all key performance indicators exceeded

**Introduction**

Better regulation is now integral to all Ofgem's decisions. We promote competition where possible and regulate only when necessary. We also commit to setting out the costs and benefits, as well as the social and environmental impacts, of everything that we do.

This year was the first that we operated, and prioritised our work under, our RPI-3 per cent cost control regime which is set to run for five years and will lead to a reduction in excess of £8 million, in real terms.

In direct response to concerns raised with us by stakeholders about the burden of consultation documents, we launched 'Project Paperless' which sought to improve our consultation, reporting and review processes.

RPI-3 – the first year

The first year of life under the RPI-3 per cent cost control regime has come to its conclusion and not only have we met our £1.1 million target for 2005-2006, we also found an extra saving of £2.9 million which will be returned to licence payers in 2006-2007.

These figures prove that Ofgem practices what it preaches. The year's savings have been achieved through good planning and prioritisation of work and the additional sum saved reflects the fact that we have had fewer staff in post than expected and have used fewer consultants.

The Gas and Electricity Markets Authority

Ofgem is governed by the Gas and Electricity Markets Authority which sets all major decisions and policy priorities. The Authority is made up of independent non-executive and executive members, with a majority of non-executives.

Ofgem has a strong corporate structure. The Authority is supported by a Senior Management Team and committees

that have clear terms of reference. The Audit Committee, Remuneration Committee and Enforcement Committee provide the necessary structure to ensure that there is a strong framework of internal control throughout the organisation.

Better regulation initiatives

The Hampton Report, published in March 2005, focused on the need to reduce the administrative burden imposed by regulators. The Arculus (Better Regulation Task Force) Report, published at the same time, recommended that Government sets targets for reducing the administrative burden on business.

Ofgem's initiatives are very much in tune with the objectives of these two key reports and we are committed to better regulation principles.

Ofgem is alive to the fact that there is a delicate balance between adhering to better regulation principles at all times, and meeting the demands placed on us by new duties and our stakeholders. We are confident that we can meet this challenge and continue to provide best value for money for consumers who remain our first priority.

There have been many examples of how we have applied better regulation principles during the year, which are highlighted in this report.

The Supply Licence Review (see 'Creating and sustaining competition', page 11) is Ofgem's major project aimed at radically simplifying the licences held by energy suppliers. On industry code modifications, we have hit the challenging targets we set ourselves for dealing with proposals more quickly. We have also taken steps to create a single distribution, connection and use of system agreement (DCUSA) to replace some 400 bilateral agreements (see 'Regulating network monopolies', page 17).

We have streamlined reporting requirements in relation to suppliers' social obligations so that 50 per cent less data has to be provided to Ofgem. We have also published reports of the Authority's monthly meetings for the first time and held a public session to discuss the Corporate Strategy and Plan.

During the year, we set up a smaller Better Regulation Unit to take up better regulation issues within Ofgem and to co-ordinate our contribution to wider Government better regulation initiatives.

In publishing our Strategy this year, we included, for the first time a Simplification Plan. This highlights the key initiatives that we are pursuing aimed at reducing the administrative burden on business.

Project Paperless

In our Corporate Strategy and Plan last year, we undertook to improve the length and readability of our documents following comments received during consultation, and reflecting our commitment to the Better Regulation agenda.

In order to address these issues, we launched 'Project Paperless' in June of last year and sought an independent view of the quality, relevance, quantity and timeliness of Ofgem's written product - consultation and decision documents. The project produced a number of recommendations which were taken forward during the year. Phase II of this project will be delivered during 2006-2007.

We also said that we expected to reduce the number of documents we produced by 20 per cent by March 2006 compared to the previous year. In fact, we reduced the number of documents we produced by 25 per cent compared to 2004-2005. We are confident that the changes we are making will lead to significant improvements in the accessibility of our written product which we see as essential in enabling effective consultation.

Impact assessments

Ofgem takes very seriously the need to publish Impact Assessments for all important new policy proposals. We believe they are an important tool for improving the quality of our analysis and providing a consistent framework for consultation on important decisions. We continue to evolve our approach to Impact Assessments in line with best practice.

Freedom of information

The Freedom of Information (FOI) Act 2000 came into force on 1st January 2005 and 2005-2006 was the first full financial year of operation. During this period, we received 433 questions, of which 411 (94.5 per cent) were answered within the statutory deadlines (20 days in most cases). Only three questions were referred to the Information Commissioner.

Throughout the period Ofgem consistently answered over 90 per cent of the questions received in full. A Financial Times survey in December 2006 ranked Ofgem among the 'best in class' in terms of Government Departments responding to FOI requests. In common with many organisations we saw a slight decline in the number of FOI requests quarter-by-quarter in 2005-2006, but at the same time, a steady rise in the complexity of questions.

People development

A number of initiatives were launched during the year, most notable of which were:

- a new Competency Framework which provides clarity and transparency of what is expected of staff at each level of the organisation and provides a framework for training and development to drive improved performance, and
- a Graduate Management Training Programme to provide a constant talent stream of high-calibre graduates who have the potential to be 'fast-tracked' to fill key posts. The programme has also offered the opportunity to enhance the Ofgem 'brand' as an employer of choice with an innovative advertising campaign and development of a graduate website.

Recruitment and retention

Continued emphasis was placed during the year on retaining, recruiting and developing staff to ensure the organisation remains well-equipped to deliver the policy priorities set by the Authority.

In 2005-2006 average staff numbers were 274, 6 per cent lower than the previous year. Staff turnover, 28 per cent five years ago, was 14 per cent in 2005-2006, in line with the 15 per cent 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
- 43 per cent of staff in managerial grades were women
- 26 per cent of senior civil service members in Ofgem were women
- 18 per cent of staff were known to be of ethnic minority origin
- 16 per cent of staff known to be of ethnic minority origin were in managerial grades, and
- 0.3 per cent of staff were known to be disabled.

Further initiatives are planned for the coming year. We will see the launch of a Management Development programme to raise management skills and capability (underpinned by the new competency framework) and changes to the pay structure to support recruitment and retention.

Financial review

In 2005-2006, Ofgem received income of £52.4 million, of which £46.7 million was received from licence fees. Of this, £13.0 million was collected on behalf of the Department of Trade and Industry (DTI) to meet energywatch and other DTI costs. Other income, mainly from property, totalled £5.7 million.

Operating costs in 2005-2006 amount to £36.1 million, compared with £36.5 million and £37.3 million in 2004-2005 and 2003-2004 respectively. 2005-2006 operating costs include £3.9 million accommodation costs recharged to tenants. Payroll (45 per cent), contractors (16 per cent) and accommodation (24 per cent) accounted for 85 per cent of the total.

A saving of £2.9 million from licence fees was made in 2005-2006. This will be offset against future licence fees charges in 2006-2007 as determined under the RPI-X cost control regime. The carry-forward amount is £3 million.

Ofgem's budget is approved by Parliament following a consultation process with industry and other interested parties. For 2005-2006 Parliament approved a resource budget of £38.0 million. In addition, DTI directed that a sum of £13.0 million should be collected on behalf of energywatch. This amount was transferred to DTI, in full.

In April 2005, £10 million was drawn from the Contingency Fund to provide short-term liquidity until the first receipt of licence fees. This was repaid in full in July 2005.

The balance sheet at 31 March 2006 shows Negative Taxpayer's Equity of £7.9 million. This reflects the inclusion of liabilities falling due in future years which are to be financed mainly by drawings from the UK Consolidated Fund. Such drawings will be from Grants of Supply approved annually by Parliament to meet our Net Cash Requirement.

Ofgem's financial statements are shown in Appendix IV. More detailed information on costs can be found in our Resource Accounts published separately (HC 1104).

Our performance against deliverables is detailed in Appendix I.

Sustainability

In February 2002, we gained certification to ISO14001 standard for our internal operations activities and kept the standard year-on-year.

The standard refers to Operations matters and does not extend to Ofgem's statutory regulatory functions and duties. As part of this process, we have set up an internal Environment Team that is responsible for defining and reviewing our internal environmental impacts, objectives and targets. The team is responsible for ensuring that the environmental targets set in respect of the ISO14001 standard are met.

We have implemented many energy saving initiatives, for example:

- our Combined Heat and Power (CHP) unit, installed in 2003, has to date saved 829 tonnes of carbon dioxide

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- replacing four boilers has provided a 35 per cent improvement in domestic heating efficiency
- sensors are being installed to automatically switch off all non-emergency lighting in unoccupied office areas
- 10 per cent of externally supplied electricity is generated from renewable sources, and
- recycling paper, cardboard, glass, cans and plastic results in an indirect reduction in power generation.

These energy saving initiatives are continuing; for example a programmes of water saving measures is being rolled out in 2006.

Appendix I

Ofgem's performance against 2005-2006 deliverables

Ofgem's Plan and Budget for 2005-2006 published 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. The deliverables are listed by the quarters in which they were due to be completed.

The total achievement of 87 per cent within the year 2005-2006 is against an internal target of 75 per cent.

	Total Number	Achieved in Year			Not completed In year	Not applicable
		In target Quarter	In later Quarter	Total		
Q1	18	12 (67 per cent)	6 (33 per cent)	18 (100 per cent)	0	0
Q2	18	10 (56 per cent)	4 (22 per cent)	14 (78 per cent)	2 (11 per cent)	2 (11 per cent)
Q3	11	8 (73 per cent)	2 (18 per cent)	10 (91 per cent)	0	1 (9 per cent)
Q4	6	4 (67 per cent)	-	4 (67 per cent)	1 (17 per cent)	1 (17 per cent)
Total	53	34 (64 per cent)	12 (23 per cent)	46 (87 per cent)	3 (6 per cent)	4 (8 per cent)

Creating and sustaining competition

Activity	Action	Delivery period	Completed
Cash Out Review	Conclude review of gas and electricity cash out arrangements	Q2	Late Q3
Connections	Implement, by 1st April 2006, new Standard Special Licence Condition for all gas distribution networks in respect of scope of emergency service to be offered to independent gas transporters	Q4	N/A
Electricity SO Incentives	Start development of enhanced shallow SO incentives for NGC in its role as GB SO in the electricity market from April 2007	Q2	Not in year
	Develop and Implement enhanced shallow SO incentives for NGC in its role as GB SO in the electricity markets from 1 April 2006 to 31 March 2007	Q4	Q4
Gas Balancing Arrangements	Report on the performance of the gas balancing indicators	Q2	N/A
	Report on the performance of the gas balancing indicators	Q4	N/A
Gas Quality	Conclude review of existing gas quality arrangements	Q3	Achieved
Gas SO Incentives	Start development of enhanced shallow SO incentives for Transco in its role as GB SO in the gas market from April 2007	Q2	Not in year
LNG Funding	Conclude development of appropriate funding arrangements for LNG	Q3	Not in year
Market Infrastructure	Liaise with and support the work of the Customer Transfer Programme	Q1	Achieved
Modifications	Publish review of reconciliation by difference in gas	Q4	Achieved
Offshore Information Release	Consult (implement if appropriate) and reform of onshore regulatory arrangements to facilitate information release	Q2	N/A

(Creating and sustaining competition continued)

Activity	Action	Delivery period	Completed
Retail Competition	Supply Licence Review – commence review	Q1	Achieved
	Domestic monitoring – quarterly website updates of key indicators	Q1-Q4	Late Q4
	Non-domestic markets - consult on carrying out further review of non-domestic supply sectors	Q1	Late Q3
	Metering - Consult on framework/scope /indicators for a competitive market review	Q2	Late Q4

Regulate monopoly networks

Activity	Action	Delivery period	Completed
Connections	Publish final proposals for new Standard Licence Condition to prohibit undue discrimination by electricity distribution networks in the provision of non-contestable connections information and services	Q2	Achieved
DN Sales	Consent to transfer of licences to gas distribution businesses to be sold by Transco plc and approve revised Network Code	Q1	Achieved
Electricity & Gas Transmission	Publish initial consultation on electricity and gas transmission price control reviews	Q1	Late Q2
	Publish initial consultation on structure of electricity transmission charges for embedded generation	Q2	Achieved

▶ 42 Ofgem's performance against 2005-2006 deliverables

(Regulate monopoly networks continued)

Activity	Action	Delivery period	Completed
Electricity & Gas Transmission	Publish, jointly with DTI, initial consultation on the regulatory regime for offshore transmission	Q2	Achieved
	Publish second consultation on electricity and gas price control reviews	Q3	Achieved
Electricity Distribution policy	Publish initial consultation on longer term electricity distribution charging arrangements	Q1	Achieved
Electricity distribution price control review	Publish conclusions of review of 2004-2005 electricity distribution price control review (DPCR4)	Q2	Achieved
	Publish summary cost information for electricity distribution companies for 2004-2005	Q3	Achieved
Gas Distribution Policy	Publish final proposals for gas distribution structure of charges	Q2	Late Q3
Modifications	Publish procedures for complaints and dispute resolution under Articles 23 & 25 of the Gas and Electricity Directives	Q1	Achieved
	Publish decision document on Distribution CUSC	Q1	Late Q3
Networks	Following the closure of the 2004-2005 Asset Risk Management Survey, Ofgem is migrating from an industry-led certification to BSI PAS-55 (good practice asset management framework).	Q3	Late Q4
Quality of Service	Publish annual reports for 2004-2005 on electricity and gas distribution quality of service	Q3	Achieved

Ofgem's performance against 2005-2006 deliverables ◀ 43

Protect security of energy supply

Activity	Action	Delivery period	Completed
Security of supply	Publication of conclusions document following consultation on NGTs information release licence condition	Q1	Achieved
Security of supply reporting - Winter Outlook	Publication of NGT winter outlook reports	Q2	Achieved
Security of supply reporting - Energy Act and JESS Report	Security of supply report under Energy Act	Q2	Achieved
	Joint Energy Security of Supply Report	Q3	Achieved

Leading voice in Europe

Activity	Action	Delivery period	Completed
Europe	Publish CEER report assessing the factors which inhibit the development of regional markets in Europe and key factors which inhibit interactions between regional markets and make proposals for improvement	Q1	Achieved
	Complete the initial process for the UK Ireland/France mini forum as requested in the Florence Forum and report to the next Florence Forum	Q1	Achieved
	Start development of CEER 'Road Map' which will define the necessary interactions between regions for the realisation of a single energy market	Q2	Achieved
	Ensure that unbundling of gas and electricity networks is closely monitored and that reports are prepared by the CEER on the effectiveness of unbundling, in particular in the benchmarking report	Q3	Achieved

Protecting the environment

Activity	Action	Delivery period	Completed
CHP	Publish administration procedures for non-exporting CHP operators	Q1	Late Q3
Energy efficiency	Produce final report on supplier compliance with the Energy Efficiency Commitment	Q2	Achieved
Environment Issues	Publish Environmental Action Plan annual report	Q1	Late Q2
Fossil Fuel Levy	Set the Fossil Fuel Levy annually (from time-to-time in Scotland) and to ensure that it is collected	Q3	Achieved
Renewables	Publish administration procedures for Northern Ireland generators	Q1	Achieved
	Submit response to DTI preliminary consultation on 2006 Renewables Obligation Review	Q1	Achieved

Tackle fuel poverty

Activity	Action	Delivery period	Completed
Social Action Plan	Publish Social Action Plan for 2005 – 2010	Q1	Achieved
	Publish review of the effectiveness of the Priority Service Register, based on joint research with Energywatch	Q3	Achieved
	Supply licence review - consult on issues relating to vulnerable customers	Q4	Achieved

Better regulation

Activity	Action	Delivery period	Completed
Consultation	Report on the preparation of consultation documents	Q2	Achieved
Licensing	Launch Electronic Public Register	Q2	Achieved
Scotland Office	Establish Scottish Energy Regulation Forum, for discussion of gas and electricity issues between all parts of Government in Scotland	Q1	Achieved

Regulatory Impact Assessments undertaken 2005-2006

Investigations and enforcement action 2005-2006

12 Impact Assessments published by Ofgem 1 April 2005 - 31 March 2006

111/05	Approval of statement pursuant to special condition J2 (Basis of transmission owner charges) of SP Transmission Limited's ("SPTL") transmission licence
112/05	Approval of statement pursuant to special condition J2 (Basis of transmission owner charges) of Scottish Hydro Electric Transmission Limited's ("SHE TL") transmission licence
137/05	Governance in the Electricity Distribution Commercial Arrangements – Impact Assessment
173/05	Gas Distribution Structure of gas distribution charges - Initial proposals
178/05	Regulation of offshore electricity transmission - a joint consultation by DTI/Ofgem
188/05	Section 23 notice to modify Transco's Gas Transporter Licence: Explanatory note to accompany proposals for new entry points to Transco's National Transmission System
220/05	Notice under section 11A (1) and (3) of the Electricity Act 1989 (Distribution)
221/05	Notice under section 11A (1) and (3) of the Electricity Act 1989 (Transmission)
243/05	Modification proposal 049 'Optional Limits for Inert Gases at System Entry Points' - Impact assessment
17/06	BSC modification proposal P194 'Revised Derivation of the Main Energy Imbalance Price' - Impact assessment
22/06	UNC modification proposal 006 '3rd Party Proposal: Publication of Near Real Time Data at UK sub-terminals
104d/06	Transmission Price Control Review Initial Proposals: Draft Enduring Offtake Impact Assessment

Company	Issue	Decision	Date of decision
British Gas Trading Ltd	Compliance with obligations regarding the vetting of applicants for meter reading posts	Not in breach	7 April 2005
Southern Electric Gas Limited / SSE Energy Supply Ltd	Marketing practices	No further action	1 June 2005
Transco plc	Failure to meet standards of performance obligations	In breach but no penalty appropriate	13 June 2005
TXU UK Ltd	Failure to meet targets for energy savings under the Electricity and Gas (Energy Efficiency Obligations) Order 2001	In breach but no further action possible as company in administration	20 July 2005
Atlantic Electric & Gas Ltd	Failure to meet targets for energy savings under the Electricity and Gas (Energy Efficiency Obligations) Order 2001	In breach but no further action possible as company in administrative receivership	20 July 2005
Atlantic Electric & Gas Ltd	Failure to make a "buyout" payment in lieu of its obligations to demonstrate that a proportion of the electricity which it supplied came from renewable sources.	In breach but no further action possible as company in administrative receivership	30 August 2005
SP Manweb plc	Competition Act 1998 – abuse of dominant market position by discriminating in the provision of connections	Accepted commitments made under section 31A of the Act	27 October 2005
SP Manweb plc	Failure to comply with distribution licence obligations on information reporting	Undertakings accepted and licence modification proposed	10 January 2006

Ofgem's financial statements (extracts) 2005-2006

Operating cost statement

for the year ended 31 March 2006 (£000s)

	2005-2006		2004-2005
	Staff Costs	Other Costs	Income
Administration costs			
Request for resources 1:			
Staff costs	16,511		16,571
Non-staff administration costs		19,424	19,196
Operating income			(35,766)
Request for resources 2:			
Non-staff administration costs		593	700
Programme costs			
Request for resources 1			
Expenditure		117	13,363
Income			(13,363)
Totals	16,511	20,134	(36,051)
Net operating cost			701

All income and expenditure are derived from continuing operations.

Statement of recognised gains and losses

for the year ended 31 March 2006 (£000s)

	2005-2006	2004-2005
Net operating cost	(594)	(701)
Net gain on revaluation of tangible fixed assets	4	33
Overnight change in pension liability	(29)	-
Actuarial loss on revaluation of pension liabilities	(31)	(42)
Recognised losses for the financial year	(650)	(710)

Balance sheet

as at 31 March 2006 (£000s)

	31 March 2006	31 March 2005
Fixed assets		
Tangible assets	4,113	4,463
	<u>4,113</u>	<u>4,463</u>
Current assets		
Debtors	2,592	3,978
Cash at bank and in hand	3,244	2,632
	<u>5,836</u>	<u>6,610</u>
Creditors (amounts falling due within one year)	(12,812)	(10,174)
Net current liabilities	(6,976)	(3,564)
Total assets less current liabilities	(2,863)	899
Creditors (amounts falling due after more than one year)	(3,239)	-
Provisions for liabilities and charges	(1,359)	(5,946)
Total net liabilities before pension liability	(7,461)	(5,047)
Pension liabilities	(407)	(340)
Total net liabilities	(7,868)	(5,387)
Taxpayers equity		
General fund	(7,899)	(5,422)
Revaluation reserve	31	35
	<u>(7,868)</u>	<u>(5,387)</u>

Cash flow statement

for the year ended 31 March 2006 (£000s)

	2005-2006	2004-2005
Net cash inflow/(outflow) from operating activities	2,373	(3,728)
Capital expenditure and financial investment	(726)	768
Receipts due to the Consolidated Fund which are outside the scope of the Department's activities	-	1,982
Payments of amounts due to the Consolidated Fund	(2,632)	(4,682)
Financing	1,597	7,556
Increase in cash in the period	612	360

