



O f g e m A n n u a l R e p o r t

2006-2007

Protecting the interests of consumers

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ofgem

Ofgem Annual Report 2006-2007

Report of the Gas and Electricity Markets Authority for the period 1 April 2006 to 31 March 2007 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 sets policy priorities.

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.

Ordered by the House of Commons to
be printed 23 July 2007
London: The Stationery Office
HC 823

Contents



1 Foreword by the Chairman 04-07



2 The Gas and Electricity
Markets Authority 08-09



5 Regulating network
monopolies 20-25



6 Helping to protect the
security of Britain's energy supply 26-29



9 Helping to tackle
fuel poverty 38-41



10 Better regulation 42-46

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3 Introduction by the Chief Executive 10-13



4 Creating and sustaining competition 14-19



7 A leading voice in Europe 30-33



8 Helping to protect the environment 34-37

Appendix I 47-51
Ofgem's performance against 2006-2007 deliverables

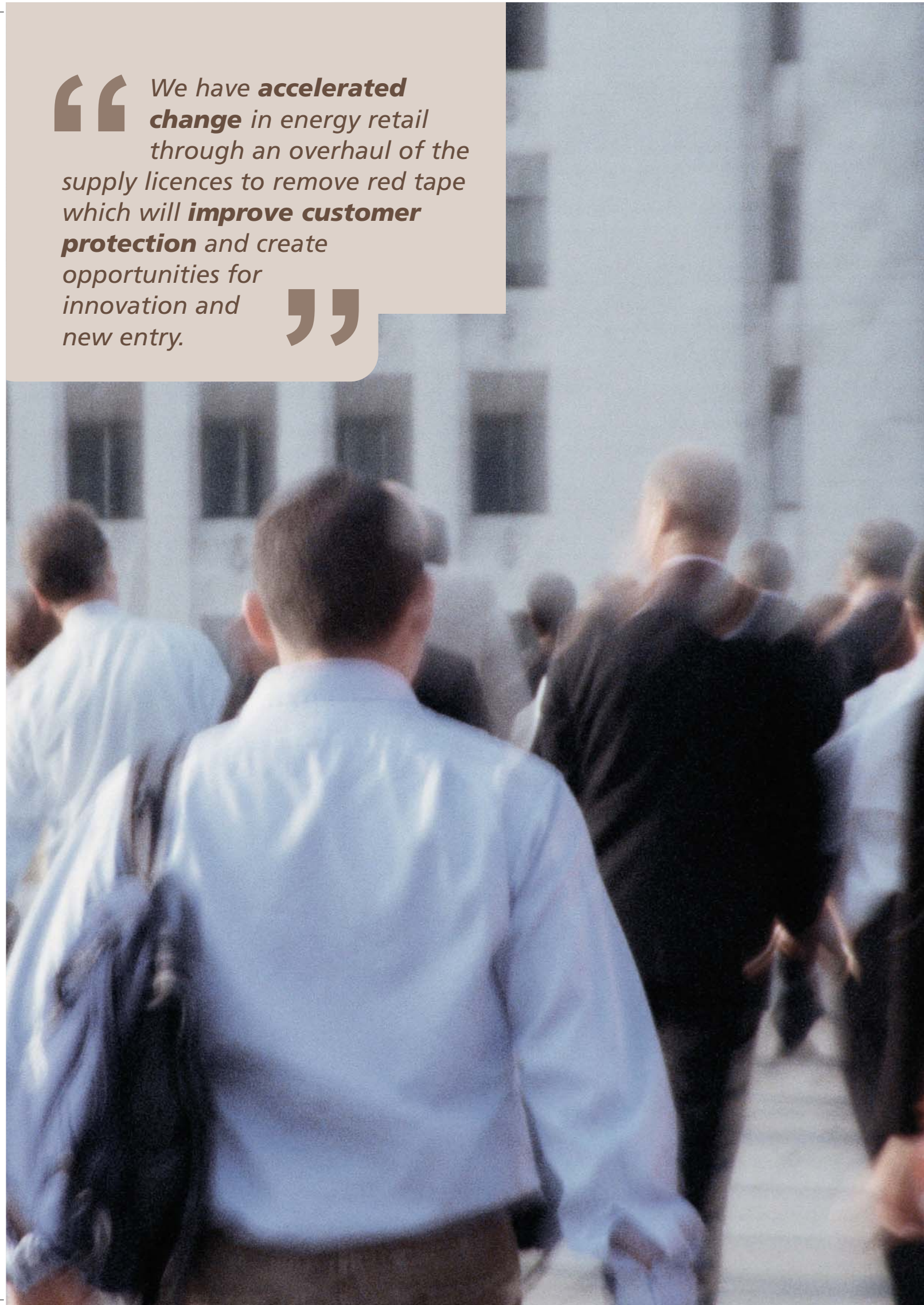
Appendix II 52-53
Impact Assessments undertaken - 2006-2007

Appendix III 54
Investigations and enforcement action - 2006-2007

Appendix IV 55-57
Financial statements (extracts) 2006-2007

The Ofgem Resource Accounts for 2006-2007 are published separately

“ We have **accelerated change** in energy retail through an overhaul of the supply licences to remove red tape which will **improve customer protection** and create opportunities for innovation and new entry. ”



Cash flow statement

for the year ended 31 March 2007 (£000s)

	2006-2007	2005-2006
Net cash inflow/(outflow) from operating activities	(4,167)	2,373
Capital expenditure and financial investment	(754)	(726)
Receipts due to the Consolidated Fund which are outside the scope of the Department's activities	255,000	-
Payments of amounts due to the Consolidated Fund	(256,647)	(2,632)
Financing	6,019	1,597
(Decrease)/Increase in cash in the period	(549)	612

Operating cost statement

for the year ended 31 March 2007 (£000s)

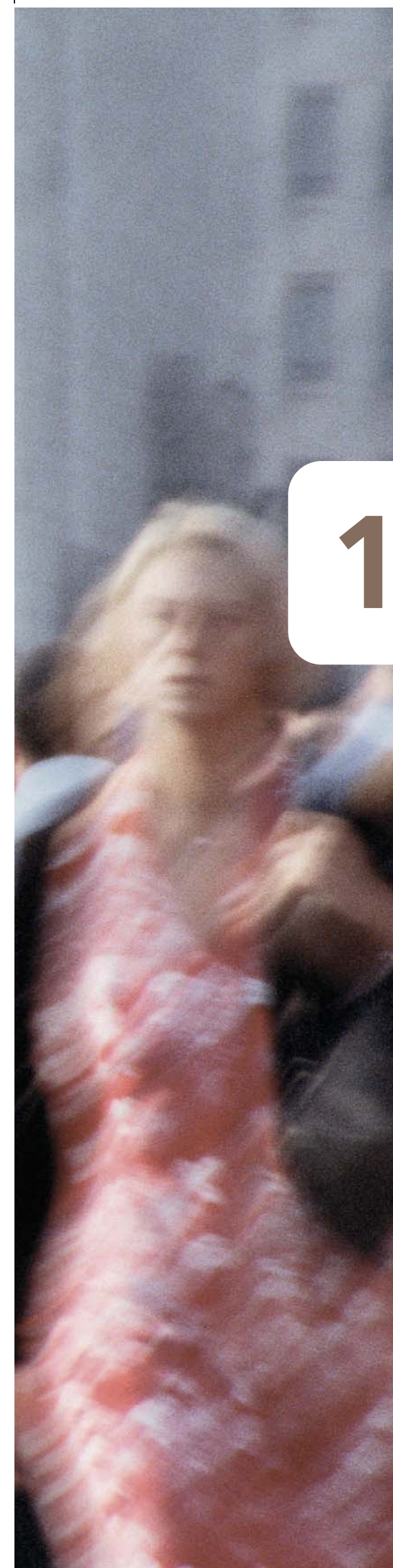
	2006-2007		2005-2006
	Staff Costs	Other Costs	Income
Administration costs			
Request for resources 1:			
Staff costs	18,610		16,511
Non-staff administration costs		20,198	19,424
Operating income			(38,807)
Request for resources 2:			
Non-staff administration costs		645	593
Programme costs			
Request for resources 1			
Expenditure		55	117
Income			(55)
Totals	18,610	20,898	(38,862)
Net operating cost			646

All income and expenditure are derived from continuing operations.

Statement of total recognised gains and losses

for the year ended 31 March 2007 (£000s)

	2006-2007	2005-2006
Net operating cost	(646)	(594)
Net (loss)/gain on revaluation of tangible fixed assets	(19)	4
Overnight change in pension liability	-	(29)
Actuarial loss on revaluation of pension liabilities	(59)	(31)
Recognised losses for the financial year	(724)	(650)



1

Foreword by the Chairman

Change currently dominates the energy landscape. Change has figured still more in the past year as European and UK policy and market trends continue to evolve. Ofgem has sought not only to respond to such change but also to anticipate it and, on occasion, to accelerate certain elements of this change.

Thus we have responded to the need for greater investment in infrastructure through our recent reviews of controls on the network monopolies. We anticipated that competition would arrest the rise of wholesale energy prices in the UK and attract new imports. We promoted retail competition in a number of ways including encouraging customers to take advantage of the savings available through switching supplier. And we have accelerated change in energy retail through an overhaul of the supply licences to remove red tape which will improve customer protection and create opportunities for innovation and new entry.

A particularly notable change has been the further development of regulation of network monopolies beyond revenue control and efficiency gains. Our last round of price controls on the transmission networks for the five years to 2012 included features that addressed key environmental challenges.

Our review of the price controls for the electricity and gas transmission companies raised their capital expenditure

“ *The UK's competitive market has attracted £10 billion in infrastructure investment.* ”

distribution networks – we started to put together gas distribution's first set of separate price controls. This will take gas distribution into regulatory territory currently occupied by its electricity counterpart and where we compare the companies' performances to get an even better deal for customers.

allowances to meet the need to renew ageing assets and accommodate the development of renewable energy.

And last year – the first since National Grid's sale of half of the eight gas

Making sure the industry invests to meet the changing demands on Britain's gas and electricity networks and invests efficiently is a challenging balancing act. It is a testament to Ofgem's expertise that it has done this while also creating latitude for the companies to respond to unexpected demand and encouraging innovation to deal with new forms of generation.

Ofgem combines independent regulation of monopolies with promotion of competition to meet customers' needs. Energy prices have climbed in recent years causing difficulty for all consumers, particularly those on low incomes and other vulnerable groups. An earlier downturn in fuel poverty was sadly reversed. But in promoting competition Ofgem has sought to harness a chief cause of the price rise burden – greater UK exposure to overseas markets – as a key part of the solution.

The nation's exposure to the global energy market has increased as our self-sufficiency in gas has declined. A short-term effect of this has been a hike in the price of energy. But the UK's competitive market has attracted £10 billion in infrastructure investment with upgrades in existing gas links to the rest of Europe and new ones from outside and within the European Union.

New sources of gas coming into the UK, particularly the emergence of liquefied natural gas, have injected greater competition into the wholesale gas market bringing lower prices and greater security of supply to the UK. The halt last year in wholesale energy price rises was a particularly welcome development.

For the European Union, the need to inject competition in the energy markets has taken on a greater than ever importance. At the start of the year the European Commission signalled its determination to dismantle the obstacles to a single pan-Europe market presented by huge vertically integrated companies.

Ofgem's contribution to the Commission's policy development has been a central one and that is

Appendix IV

Ofgem's financial statements (extracts) 2006-2007

Balance sheet

as at 31 March 2007 (£000s)

	31 March 2007	31 March 2006
Fixed assets		
Tangible assets	3,996	4,113
	3,996	4,113
Current assets		
Debtors	3,838	2,592
Cash at bank and in hand	2,695	3,244
	6,533	5,836
Creditors (amounts falling due within one year)	(9,411)	(12,812)
Net current liabilities	(2,878)	(6,976)
Total assets less current liabilities	1,118	(2,863)
Creditors (amounts falling due after more than one year)	(2,922)	(3,239)
Provisions for liabilities and charges	(1,553)	(1,359)
Total net liabilities before pension liability	(3,357)	(7,461)
Pension liabilities	(474)	(407)
Total net liabilities	(3,831)	(7,868)
Taxpayers equity		
General fund	(3,835)	(7,899)
Revaluation reserve	4	31
	(3,831)	(7,868)

Appendix III

Investigations and enforcement action 2006-2007

Company	Issue	Decision	Date of decision
SP Manweb plc	Investigation into compliance with obligations in its distribution licence relating to the reporting of units distributed and losses.	Undertakings accepted in respect of SP Manweb plc and SP Distribution Limited and licence modification proposed.	10 Jan 2006
Global Utility Connections Ltd	Investigation into how Global Utility Connections Ltd, an independent distribution network operator, complied with its obligations under standard condition 14 (Provision of the Metering Point Administration Service and Compliance with the Master Registration Agreement), standard condition 6 (Safety and Security of Supplies Enquiry Service), standard condition 29 (Disposal of Relevant Assets) and various financial ring fencing obligations under its licence and with the Electricity Act 1989.	Findings of breach but no penalty imposed.	22 August 2006
EDFE	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 abuse of dominance, which is an infringement of the Chapter II prohibition of the Competition Act 1998 and Article 82 of the EC Treaty.	Non-infringement	25 January 2007
CE Electric licensess: Northern Electric Distribution Limited and Yorkshire Electricity Distribution plc	Investigation into non-compliance with standard licence condition 49 (Quality of Service Incentive Scheme and Associated Information) by Yorkshire Electricity Distribution plc and Northern Electric Distribution Ltd.	Findings of breach - modifications to special condition C2 (Calculation of charge restriction adjustments arising from performance in respect of quality of service) proposed.	06 June 2007

continuing. Naturally these links have been strengthened through my presidency of the Council of European Energy Regulators, my chairmanship of the advisory body the European Regulators' Group for Electricity and Gas and my membership of the Commission's High Level Group on competitiveness, energy and the environment.

The energy industry terrain is changing but the need to tackle climate change remains a constant and dominating feature. The European Commission has set out a challenging target for cutting carbon dioxide emissions by 20 per cent by 2020. The government has signed up to this commitment in its May Energy White Paper, it unveiled its key policy drivers for arresting climate change and delivering a sustainable energy sector. Ofgem featured prominently in many of its initiatives and plans which were founded on our main tenets of competition and independent regulation.

Fundamental to Ofgem's operations is the ambition to reduce the burden of regulation while maintaining or raising the standards of those we regulate. This report gives accounts of how we have removed redundant supply licence conditions and condensed sprawling electricity network rules into a single agreement. And we have kept up our self-imposed cost regime to cut our operating costs and outstripped our targets in doing so.

Ofgem has led by example not only in cost management but in the diligence, rigour and creativity its staff members bring to their tasks. The future promises to offer them abundant opportunities to demonstrate further their commendable qualities.



Sir John Mogg
Chairman

The Gas and Electricity Markets Authority

2

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

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

Summary of decisions to which Impact Assessments relate

The following sets out the decisions taken from 1 April 2006 to 31 March 2007 in relation to proposals for which an impact assessment was carried out.

(22/06) Publication of near real-time data at UK sub-terminals

On 3 May 2006 the Authority directed the implementation of UNC modification proposal 006. For details see:
http://ofgem2.ulcc.ac.uk/temp/ofgem/cache/cmsattach/14822_8006.pdf?wtfrom=/ofgem/whats-new/archive.jsp

(137/05) Governance in the electricity distribution commercial arrangement

On 29 August 2006 the Authority directed the designation of a Distribution Connection. Use of System Agreement with effect from 5 October 2006. For details see:
http://www.ofgem.gov.uk/Licensing/ElecCodes/DCUSA/Predesig/Documents1/15608-177_06.pdf

(214/06) WPD electricity distribution use of system charging methodology

On 1 February 2007 the Authority decided not to veto WPD's proposed changes to its electricity distribution use of system charging methodology. For details see:
<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/16856-2007.pdf>

(215/06) Charging arrangements for GB SQSS design variations

On 16 February 2007 the Authority vetoed NGET's proposed change to its transmission use of system charging methodology (GB ECM-06). For details see NGET's website:
<http://www.nationalgrid.com/NR/rdonlyres/491F2854-660F-462C-9E0D-BAF41A8B7D7A/15284/GBECM06AuthorityDecisionLetter.pdf>

(41/07) Reform of interruption arrangements on gas distribution networks

On 15 March 2007 the Authority directed that UNC modification proposal 90 be implemented and that implementation be delayed until 1 April 2008. For details see
<http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC090D.pdf>

Appendix II

Impact Assessments undertaken 2006-2007

13 Impact Assessments (IAs) published by Ofgem 1 April 2006 – 31 March 2007

(104d/06)	Transmission Price Control Review Initial Proposals: Appendix 17 Draft enduring offtake IA
(191/06)	Reform of interruption arrangements on gas distribution networks Draft IA
(169b/06)	Gas Distribution Price Control One Year Proposal Control Initial Proposals Appendices
(203/06a)	Gas Distribution Price Control Review Third Consultation Document – Appendices: Initial IAs
(214/06)	Western Power Distribution's modification proposal to change its electricity distribution use of system charging model - consultation and impact assessment
(215/06)	Charging arrangements associated with GB SQSS design variations based on customer requests – IA
(217/06)	Supply Licence Review – further proposals: Draft IA for gas safety checks and information
(23/07)	National Grid Gas Offtake Arrangements – Final IA on modification proposals
(26a/07)	Review of Competition in Gas and Electricity Connections – Proposals Document – Supplementary Appendices: Draft IA
(32/07)	Zonal Transmission Losses – assessment of proposals to modify the Balancing and Settlement Code
(38/07)	3rd Party Proposal: Storage Information at LNG Importation Facilities. Modification UNC 104
(40/07)	Charging arrangements associated with methodologies for determination of NTS entry and exit capacity prices: IA
(41/07)	Reform of interruption arrangements on gas distribution networks Final IA

Membership

Sir John Mogg
Chairman



David Gray
Executive



Dr Robin Bidwell
Non-executive



Miriam Greenwood
Non-executive



Alistair Buchanan
Chief Executive



Judith Hanratty
Non-executive



Sarah Harrison
Executive



Professor George Yarrow
Non-executive
(started in December 2006)



Jayne Scott
Non-executive



Professor Len Waverman
Non-executive

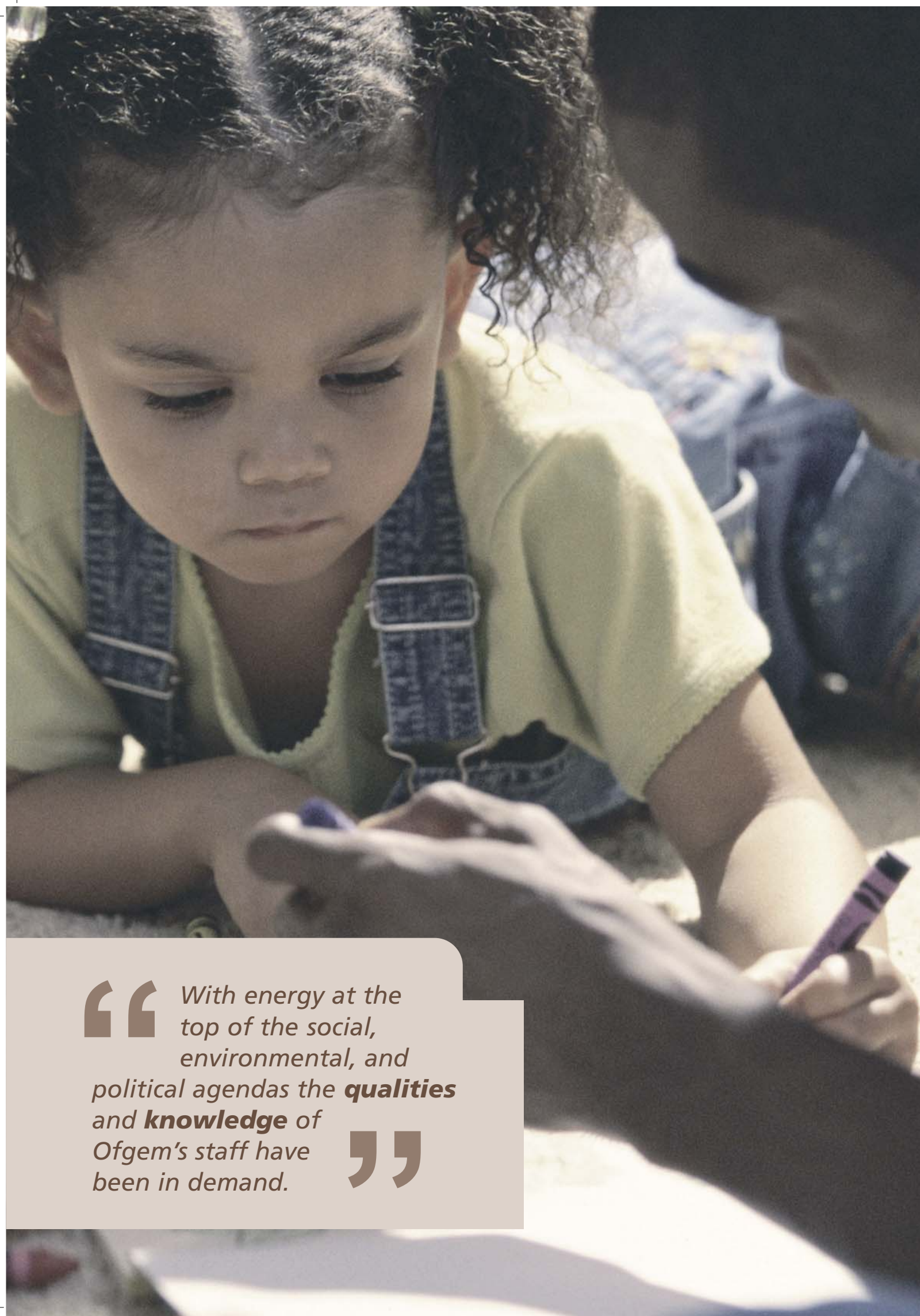


Steve Smith
Executive



John Wybrew
Non-executive





Helping to Tackle Fuel Poverty

Activity	Action	Delivery period	Result
Social Action Plan	Proposals on new licence framework for protecting vulnerable customers as part of Supply Licence Review	Q2	Q2
	Benchmarking work on the front line customer experience for vulnerable customers	Q2	Q2
	Publish follow-up on Corporate Social Responsibility Audit	Q4	Q4

Better Regulation

Activity	Action	Delivery period	Result
Industry Codes	Publish scope and programme for Industry Codes Compliance Review	Q1	Q1
Better Regulation	Apply Project Paperless principles to industry code modification and derogation decisions	Q2	Q2
	Introduce electronic document navigation and website redesign	Q4	Q4
	Conduct audit of stakeholders' views on Ofgem communications, including impact of Project Paperless	Q4	Q4

“ With energy at the top of the social, environmental, and political agendas the **qualities** and **knowledge** of Ofgem's staff have been in demand. ”

A Leading Voice in Europe

Activity	Action	Delivery period	Result
Europe	Obtain approval from ERGEG for Gas Balancing Good Practice Guidelines	Q1	Q1
	Ensure ERGEG consults on Guidelines for Good Practice on Information Management and Transparency in EU electricity markets	Q2	Q2
	Obtain a commitment from the other regulators to the regional gas initiatives work under the gas roadmap	Q3	Q3
	Ensure that monitoring of the Gas Balancing guidelines is carried out	Q4	Q4
	Work to ensure compensation mechanism between European Transmission System Operators is agreed and enters into force in 2007	Q4	Q4
	Ensure that the regional initiatives on gas hubs incorporate hubs relevant to the GB market	Q4	Q4
	Assist DG Competition in coming forward with effective proposals from the sectoral review	Q4	Q4

Helping to Protect the Environment

Activity	Action	Delivery period	Result
Energy Efficiency	Publish a review of the first year of the Energy Efficiency Commitment 2005-2008	Q2	Q2
Renewables & CHP	Publish guidance for generators on fuel measurement and sampling requirements under the Renewables Obligation	Q1	Q1
	Publish updated guidance on the administration of the Renewables Obligation to reflect changes resulting from the RO Review	Q1	Q1
	Publish annual report on the RO	Q4	Q4
Fossil Fuel Levy	Set the Fossil Fuel Levy Rate for 2007-2008	Q3	Q3
Environmental Policy	Publish Environmental Action Plan Annual Report	Q1	Q3



3

Introduction by the Chief Executive

Last year I wrote that the 'f' in Ofgem could well represent our facilitation role for consumers. This has continued as a core function but for this year, the 'f' is also for future: future customers, future investment to maintain a world-class network, and efficient future markets.

'Looking forward' is the best description of the price review we did in the past year: the transmission price control review. We continued the trend (started in the 2004 electricity distribution price control) of a substantial increase in capital expenditure. While we continued to exert control on operating expenses the main message was that our RPI-X methodology has moved from a phase of 'save' to 'spend'. The reasons are simply put: future reliability of networks requires this spend, and future consumers expect, where it is economic, renewable power sources to be connected.

Allowances for investment in the electricity transmission networks were increased by 126 per cent to £3.79 billion. This included £530 million of investment which we approved in December 2004, well ahead of the main price control review, to ensure that lack of funding would not be an obstacle to investment in support of renewable generation.

We also introduced a range of sustainability initiatives into the networks, such as losses incentives, innovative technology payments, and incentives for controlling emissions of carbon dioxide and SF₆ – a potent climate-change gas used in network equipment.

While the Government's renewable and carbon targets impacted our price control work the fuel poor targets were ever present in our thinking in 2006-2007. This was made all the more urgent by the surge in number of those in fuel poverty due to the much higher prices seen in the past year. Examples from the past year where Ofgem has facilitated help for vulnerable consumers include: spearheading a winter programme aimed at 100,000 vulnerable customers, promoting best practice among energy companies, research on awareness of social measures and backing work on ways to identify households most likely to be in fuel poverty.

A key element of our message to the fuel poor was – and will continue to be – to take advantage of switching. The savings are greatest to the 50 per cent who have not switched, and although retail prices have fallen since their peak our message has not diminished. Indeed with the firm power prices predicted this winter we remain committed to this message. We supported the concerns, raised by many, of the plight of those who suffered the lack of meter recalibration and faced back-dated debt as a result. Our name and shame programme has moved things on significantly from 2006. Unfortunately tackling prepayment meter concerns is not the silver bullet for fuel poverty, as less than 20 per cent of fuel poor use such meters.

Before linking the work of 2006-2007 with that of 2007-2008 and beyond, it is worth highlighting that 2007-2008 represents a unique set of opportunities for Ofgem:

- ▶ in our networks business we have a chance to 'take the temperature' on price controls, because 2008 is a rare year for Ofgem as we have no price controls to deliver;
- ▶ we will have to address the roles ascribed to us in the Act, and if the recently published White Paper is the "blueprint" then we will have more responsibilities – this is especially relevant in the area of sustainability;

- ▶ in Europe we will want to maintain our central role among the European regulators, as the Commission handles the third legislative package; and
- ▶ wider challenges outside Europe lie ahead for Ofgem's staff – we increasingly have to address global energy trends as liquefied gas is shipped to the UK from around the world.

In 2006-2007 Ofgem did a large amount of policy groundwork, which will become very evident from this year onwards. Three examples make the point.

- ▶ The work on creating a new regulatory regime for offshore transmission has been given momentum by Ofgem, and I am very excited by the launch of a new regulatory concept. In this process Ofgem has been challenging conventional approaches so we can get the best deal for consumers. For example we have asked whether customers would be better served if undersea cables were bid for competitively rather than awarded as a monopoly and we have agreed with Government to develop a competitive tender regime.
- ▶ Ofgem is leading the Government's smart meter pilot scheme, and we do this with zeal, as we believe that customers' interests will be better served by smart meters rather than the simplistic fascia meter.
- ▶ In Europe the whole office, led by Sir John, (as Chair of the European regulators advisory group), has invested in seeking to win as much as possible from the current energy review. As I write the three big wins are all unresolved: unbundling, independent regulators, and much improved information flows.

Last year was not just about looking at policy formulation but also seeking to get better processes for future consumers. A major project for Ofgem has been the two-year 'Supply Licence Review' – the results of which have just been published. This review set out to reduce the rules and regulations (or barriers to entry in the markets), cut red tape, and align us better with the Better Regulation Commission's guidelines. I am pleased to say that future consumers will not only benefit quantitatively but qualitatively. Perhaps the greatest boost will be to energy service companies: the 28-day rule is no more!

2006/2007 was a turning point in GB and European markets for the provision of information, and things will be a lot better going forward. In the GB market, Ofgem insisted that all gas market suppliers had to adhere to Ofgem's rules on enabling open markets – high-quality information on flows from the North Sea, and the insistence of "use it or lose it" rules on the owners of

Regulating monopoly networks

Activity	Action	Delivery period	Result
Electricity and gas transmission	Publish Transmission Price Control Review (TPCR) Initial Proposals	Q1	Q1
	Publish TPCR Final Proposals	Q3	Q3
	Publish proposals for cost reporting by transmission companies	Q4	Q4
Offshore electricity transmission	Publish proposals for offshore regulation	Q4	Q4
Electricity distribution	Award rewards under quality of service discretionary reward scheme	Q2	Q2
	Publish electricity distribution quality of service report	Q3	Q3
	Publish summary cost information for electricity distribution companies for 2005-2006	Q4	Q4
Gas Distribution	Publish initial proposals on Distribution Network interruption reform	Q2	Q3
	Publish extension review Initial Proposals	Q2	Q2
	Publish extension review Final Proposals	Q3	Q3
	Publish gas distribution quality of service report	Q3	Q3
	Final proposals for Distribution Network interruption reform	Q4	Q4
Industry Codes	Implement the Distribution Connection Use of System Agreement	Q2	Q2

Creating and sustaining competition

Activity	Action	Delivery period	Result
Retail Competition	Publish findings on whether a full review of non-domestic supply markets is required	Q1	Q1
	Publish a consultation document setting proposals for new electricity and gas supply licences	Q2	Q2
	Implement, through collective licence modification processes, new electricity and gas supply licences	Q4	Q4
	Publish initial proposals on development of metering competition and metering price controls	Q2	Q1
	Publish final proposals on metering price controls	Q3	Q3
Security of Supply report	Publish the Energy Act report on Security of Supply in conjunction with the DTI	Q1	Q2
Electricity System Operator (SO) incentive	Implement SO incentives for National Grid Electricity Transmission in its role as GB SO in the electricity market for one year from April 2006	Q1	N/A
Electricity and gas SO incentives	Publish initial consultation document for the enduring SO incentives schemes for National Grid Gas and National Grid Electricity Transmission in their roles as GB gas and electricity market SOs	Q2	N/A
	Publish Final Proposals for the enduring SO incentives schemes for National Grid Gas and National Grid Electricity Transmission	Q3	N/A
	Implement licence modifications for the enduring SO incentives schemes for National Grid Gas and National Grid Electricity Transmission	Q4	N/A
Connections	Consult on review of progress in competition in connections	Q2	Q2

import gas terminals. In Europe, Ofgem has welcomed much better information flows from the French and Belgians. We also note the strides made by the German energy companies. All such information helps the GB consumer – especially the industrial concerns.

Information provision will take another step forward in 2007-2008 across all of our activities.

- ▶ In the 'bread and butter' work of Ofgem we will be providing a long-term networks report. We intend to launch a prototype in 2008.
- ▶ In the markets area, Ofgem will be leading with the Department for Business, Enterprise and Regulatory Reform (DBERR) on a project to enhance significantly the analysis and scope of a forward-looking report. The first draft of this is hoped to be ready by the end of 2007.
- ▶ The Energy White Paper has required Ofgem to report by November 2007 on the Corporate Social Responsibility activities of the companies. This should be a useful handbook for consumers to assess the competitive offerings.
- ▶ Ofgem will launch its second sustainability report, taking lessons from its first report, but also from the Sustainability Development Commission's report on Ofgem and the Energy White Paper.

To meet the challenges during the year, and to prepare for the future, the organisation took a number of measures. Two structural changes are worthy of particular mention. We placed environmental and European activities together under a senior member of the team, not only as a signal of their importance but also to reap the benefits of the convergence of the two topics. Secondly, we renewed our approach to human resources and to training. Reorganisation and recruitment underway in our consumer and social affairs teams will enable us to have a deeper understanding of future consumer priorities.

Operationally Ofgem, under the guidance of Chief Operating Officer Roy Field, continued to deliver excellence while preparing for the future. For the second year the organisation met its budget target, and at this stage we hope to beat RPI-3 per cent in the current five-year cycle by some margin. We met our performance targets on, for example, industry code modifications, licensing and freedom of information requests, and yet again we were the first public sector body to lay annual accounts in Parliament. Finally we are very pleased with our sustainability drive within the office (see page 46).

Consumers, we hope, are already benefiting from our re-launch of the Ofgem documentation last year (Project Paperless) – certainly our paperwork is down 35 per cent in the year!! We are looking for similar 'wins' from our newly launched web site. We are also seeking to clarify for consumers our enforcement practices. All of these initiatives should make us more understandable.

With energy at the top of the social, environmental, and political agendas the qualities and knowledge of Ofgem's staff has been in demand. I am enormously grateful to the team at Ofgem for their expertise and hard graft in the past year. This has been achieved against an increasingly tough cost control which forces us to manage our resources (paid for by consumers) carefully.

These external pressures are not going to diminish and therefore the Senior Management Team is committed to assisting our staff. This ranges from better management and industry training through to running a programme that will enhance the canvas upon which we make our decisions. This is called our 'Consumer First' programme – a project designed to provide a qualitative improvement to our decision making by leading to greater understanding of current and future customers' desires and aspirations.

My opening comments focused on two 'f's – facilitation and future. Both are entwined and we place great value on listening to customers – large and small. In the past year this has ranged from my visit to Ineos Chlor at Runcorn (one of GB's largest consumers of power), to our Non Executive Directors' visit to EDF Energy's social schemes in Newham, London, through to the MORI-led discussions we have conducted with prepayment meter customers. We have continued to connect with customers through workshops and seminars with those on microgeneration and offshore transmission regulation being notably well attended. Our high-level "Powering the Energy Debate" series included a speech by Neelie Kroes, the EU Commissioner for Competition.

Ofgem will continue to place great emphasis on informing all consumers not only about what we do but also about how they can learn about the energy matters that affect and interest them.



Alistair Buchanan
Chief Executive

Creating and sustaining competition

4

Key achievements for 2006-2007

Retail

- » Halved the regulatory burden on the supply industry through a major review of the supply licence
- » Launched Consumer First – a programme to improve dialogue with energy customers to get a closer understanding of their needs and expectations
- » Made progress in realising the potential of advanced metering
- » Removed regulatory obstacles to household-scale generation

Wholesale

- » Promoted competition which drew in new diverse sources of gas for the UK
- » Revised imbalance cash-out arrangements
- » Produced early winter outlook

» 14



“
Rivalry between suppliers provides customers with choice which gives them market power.
 ”

Appendix I

Ofgem's performance against 2006-2007 deliverables

Ofgem's Plan and Budget for 2006-2007 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.

	Total in Corporate Plan	Total Achieved in Year			Not Applicable
		In target Qtr	In Later Qtr	Total	
Year Total	44	37	3	40	4
	-	84%	7%	91%	9%
Q1	9	6	2	8	1
	-	67%	22%	89%	11%
Q2	13	11	1	12	1
	-	85%	8%	92%	8%
Q3	8	7	0	7	1
	-	88%	0%	88%	13%
Q4	14	13	0	13	1
	-	93%	0%	93%	7%

» 47

Better regulation

Financial review

In 2006-2007, Ofgem received fees of £48.2 million, of which £45.3 million were licence fees. Of this, £12.2 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 £2.9 million.

Operating costs in 2006-2007 amount to £39.5 million and included £3.7 million in accommodation costs recharged to tenants. Payroll (47 per cent), contractors (15 per cent) and accommodation (21 per cent) accounted for 83 per cent of the total.

A saving of £0.6 million from licence fees was made in 2006-2007. This will be offset against future licence fees charges in 2007-2008 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 2006-2007 Parliament approved a resource budget of £39.8 million. In addition, DTI directed that a sum of £12.2 million should be collected on behalf of Energywatch. This amount was transferred to DTI, in full. Our performance against deliverables is detailed in Appendix I.

Ofgem's financial statements are shown in Appendix IV. More detailed information on costs can be found in our Resource Accounts published separately (HC 505).

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 internal operations and does not extend to Ofgem's statutory regulatory functions and duties. An internal team is responsible for defining and reviewing our internal environmental impacts, objectives and targets and for ensuring that the ISO14001 environmental targets are met.

We have implemented many energy saving initiatives. Examples include:

- ▶ our combined heat and power unit, installed in 2003, has, to date, saved 956 tonnes of carbon dioxide;
- ▶ replacing four boilers in 2003 has provided a 35 per cent improvement in heating efficiency;
- ▶ sensors have been installed to switch off all non-emergency lighting automatically in unoccupied office areas;
- ▶ 10 per cent of externally supplied electricity has been generated from renewable sources – this was increased to 100 per cent from 1 April 2007;
- ▶ paper, cardboard, glass, cans and plastic are recycled; and
- ▶ water saving measures with the capacity to save 8 million litres of water a year.



Introduction

Ofgem's policy of looking to competition in wholesale and retail markets to protect consumers' interests has continued to bring benefits. Competition puts pressure on suppliers to rein in prices and incentivises them to innovate and offer consumers diversity in products. In doing so, competition has delivered good deals for customers.

As 2006 came to a close, a long period of climbing energy prices changed trajectory. The downturn was welcomed by industry and householders alike. Even though prices were high throughout the period, domestic bills in GB remained among the lowest in Europe. GB's market-based approach, however, came under searching criticism. The previous year had been dominated by work to offset the impact of rising prices – tackling barriers to competition and monitoring prices to ensure they reflected costs and were not the result of market abuse.

Ofgem's diligence in keeping a watch over the market was made no less important by the subsequent downturn in prices. The clamour for bills to track the fall in wholesale prices was strong. So Ofgem's duty to ensure that suppliers' prices were in line with movements in wholesale prices was as important as ever.

With expectations of price falls we worked to keep customers and industry fully informed of developments. We kept up our focus on market developments to identify, and to be prepared to tackle, barriers to competition. In doing so we ensured that prices reflected supply and demand and were not the result of companies abusing market power or other market distortions. We have worked hard to provide more information to the market to help householders and industrial consumers.

Retail

Ofgem has maintained a policy of protecting customers' interests through competition where competition is possible. Rivalry between suppliers provides customers with choice which gives them market power. Half of all domestic customers have exercised that choice and by October 2006 British Gas's former monopoly of the gas retail market had been eroded by 50 per cent.

We have promoted heavily the benefits of competition not just during the period of high prices – when savings in excess of £100 a year were available to customers who had remained with the same supplier since the market was opened – but also since prices started to fall.

Switching supplier by domestic customers hit a four-year high amid the period of rising of prices. And competition has extended beyond simple price differentials into tariff innovation. Ofgem's newly introduced Domestic Retail Market Report for the year to March 2007 showed that one in five households had signed up to a fixed-price deal or another in the range of innovative tariffs being produced by suppliers. And companies are competing on quality of supply – Ofgem research showed that

The regime limits cost increases to 3 per cent below RPI. For the second year running we have outstripped our target savings cutting some £5 million from our costs in the first two years of the regime.

Project Paperless

In 2005 we implemented measures to improve the length and readability of our documents. The moves emerged from feedback from consultation, and from our commitment to Better Regulation.

The programme of improvements was known as Project Paperless. The first phase was to identify what improvements could be made looking in particular at our consultation and decision documents. A number of initiatives were implemented during 2005-2006. Phase two of this project was delivered during 2006-2007. During the year we reduced our document output by 35 per cent while making the papers easier to read.

New website

We launched our new website in spring 2007. The design was based on the outcome of consultations with stakeholders and is one we believe to be easier to navigate and more accessible to users while still containing all Ofgem publications such as consultations, reports and press releases.

Impact assessments

Drawing up Impact Assessments for all important new policy proposals contributes greatly to the quality of our analysis and helps us to be consistent in our consultations on major decisions. We have continued to evolve our processes and this year launched a review of our approach to Impact Assessments.

Freedom of information

During the period 2006-2007 we received 232 questions under the Freedom of Information Act, of which 215 (93 per cent) were answered within the statutory deadlines (20 days in most cases).

People Development

Attracting, developing and retaining staff to maintain high standards of performance is core to Ofgem's success.

We launched a number of people-based initiatives during the year. The most notable were:

- ▶ a new Competency Framework which provides clarity and transparency in 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 high-calibre graduates who have the potential to fill key posts. We have launched an advertising campaign to attract more graduates to Ofgem and we have developed a graduate website.

We plan to launch a Management Development programme framework to raise management skills and capability and review our Reward Strategy to support the increasing market place competition for talent.

Recruitment and Retention

We maintained our emphasis during the year on retaining, recruiting and developing staff to ensure the organisation remains well equipped to deliver its policy priorities.

In 2006-2007 average staff numbers were 296, compared to 278 in the previous year. Turnover continues to run at 18 per cent. We have a 15 per cent target level for turnover.

Diversity

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

- ▶ 0.3 per cent of staff were known to be disabled,
- ▶ 45 per cent of staff were women,
- ▶ 40 per cent of staff in managerial grades were women,
- ▶ 26 per cent of senior civil service members in Ofgem were women,
- ▶ 16 per cent of staff were known to be of ethnic minority origin, and
- ▶ 14 per cent of staff known to be of ethnic minority origin were in managerial grades.

Introduction

Ofgem is committed to the principles of Better Regulation – promotion of competition where possible and regulation only when necessary. Furthermore we set out the costs and benefits, and the social and environmental impacts, of everything that we do.

Better Regulation initiatives

Ofgem's outlook is entirely in line with the objective of reducing the administrative burden on industry of regulation. Ofgem has demonstrated its commitment to this key plank in the principles of Better Regulation in various ways over the past year.

The Supply Licence Review represents a major reduction in the regulatory burden on energy suppliers.

We have also overhauled the distribution, connection use of system agreement to replace some 400 separate agreements with one.

In 2006-2007, we reviewed our procedures for issuing Renewable Obligation Certificates (ROCs) and Renewables Levy Exemption Certificates (LECs). This review resulted in significant efficiency savings and enabled us to bring forward the date on which we issue the certificates each month.

Supply Licence Review

Ofgem has overhauled the supply licence conditions and removed those that no longer provide the best protection for customers (see page 17). This will halve the red tape faced by electricity and gas suppliers and reduce the cost of compliance while improving customer protection through clearer, easier to understand licence rules which are simpler to enforce.

The move is a demonstration of our commitment to achieving more through less regulatory intervention – in line with the principles of Better Regulation.

Reform of commercial arrangements in electricity distribution

The Distribution Connection Use of System Agreement (DCUSA) reduced radically the complexity of commercial arrangements in the sector (see page 24).

In line with the Better Regulation tenet guiding the new arrangements, it has a two-tier governance structure that ensures Ofgem is only involved in decisions regarding the commercial issues covered by the DCUSA when it is necessary, for example where competition or consumer protection matters are involved.

Cost control

Ofgem has continued to reduce its costs in the second year of its self-imposed, retail prices index (RPI)-linked cost control regime which is now set to cut costs by £12 million over five years.

13 per cent of energy customers said they would switch supplier to get better service.

The number of customers switching supplier in March, at 900,000, was up 200,000 on the same month a year earlier – the highest figure for four years.

Supply Licence Review

The rules governing the energy supply companies had become unwieldy with elements dating back to the early days of privatisation that ceased to apply to today's market. In 2005 we embarked on a review of those rules which came to fruition in 2007.

Ofgem's amendments stripped half of the red tape away from the supply licences and simplified the rules that remained. We expect these moves to help open the supply market to new entrants, to improve protection for vulnerable customers, and to open the path to development of energy services with, for example, the ending of the 28-day rule that discouraged suppliers from developing long-term contract offerings.

Reforming the supply licences in this way – delivering better protection of customers' interests with less regulatory burden – is a demonstration of Ofgem's commitment to the principles of Better Regulation (see page 42).

Smart meters

In 2006 we saw an increase in interest across the board in the potential social and environmental benefits that smart metering could bring. Smart metering describes meters that do more than simply log consumption. Such devices are capable of: remote reading; read outs in terms of the cost of what has been consumed; and switching automatically across multiple rate tariffs.

Ofgem has been pressing energy companies to push through the barriers preventing the widespread introduction of smart meters to give customers the potential energy and money saving this advanced technology holds. At the lowest end of their promise smart meters can end estimated energy bills. Beyond that they have the capacity to help consumers to cut their energy use, make more sophisticated tariffs available and reduce the risk of debt build-up.

Ofgem concluded from a detailed consultation that smart meters could deliver customer benefits. We concluded also that imposing a single type of smart metering onto the market was the wrong track to take because it would deny consumers choice. Ofgem believes suppliers should

be left to decide what best meets consumers' expectations of performance and cost.

Ofgem has taken a leading part in bringing industry together to address the issues that are crucial to creating a market in smart metering including standards and interoperability of technologies.

In August we invited energy firms to take part in trials to gather more evidence on how householders change their energy consumption when they have better information on how much energy they use. The trials are funded by the DBERR and Defra and managed by Ofgem.

Ofgem evaluated the bids for the £9.75 million trials, recommended their scope and will evaluate the interim results.

Microgeneration

Roof-top wind turbines, solar panels, and kitchen cupboard generators are part of a growing array of technologies that can be used to generate electricity in the home. Following a lengthy period of high prices coupled with burgeoning awareness of the environmental impact of energy consumption, interest in the prospect of home-grown power has increased. However, there remain obstacles that obstruct progress in microgeneration – mainly the need for simpler arrangements for selling surplus production to the networks.

Ofgem is helping Government to remove various planning and financial obstacles that are faced by people seeking to produce their own electricity using household-scale generators. The then Chancellor of the Exchequer called on Ofgem in his 2007 Budget to examine how homes fitted with microgeneration can benefit more from the prices paid when they sell electricity into the networks.

“ Ofgem has taken a leading part in bringing industry together to address the issues that are crucial to creating a market in smart metering. ”

Creating and sustaining competition

Ofgem has urged the supply companies to step up their efforts in microgeneration – particularly to act as a one-stop shop for guidance on installing the technology and other issues such as meeting health and safety regulations and notifying their local network operator. Ofgem's work on microgeneration ran alongside a substantive study, done jointly with the DTI, of the arrangements for distributed generation which includes microgeneration (see page 24).

Through our review of the electricity and gas supply licences we have played our part by removing regulatory obstacles from microgeneration. We have made it easier for microgenerators to take part in the Government's renewable energy support mechanism – the Renewables Obligation.

Energy Ombudsman

In summer 2006 the energy industry set up an independent Energy Supply Ombudsman and a billing code and met Ofgem's 12-month deadline to do so. The industry was charged with the task of dealing with a rising tide of complaints within a year or face formal action by Ofgem. Following a pan-industry complaint – a so-called super complaint – by energy consumer watchdog Energywatch, Ofgem challenged the industry to set up an ombudsman, end back billing and ensure customer contract terms were compliant with consumer law. All were achieved.

Wholesale

Arguably there has never been a period when awareness of wholesale prices of gas and electricity has been as

“ *The competitive market in the UK succeeded in attracting the investment to bring in new and varied sources.* ”

factors responsible for key movements and trends within the gas and electricity markets.

keen among householders as was the case during the past year.

Ofgem's leadership in providing information was demonstrated in its series of public seminars held during the winter to explain and debate the

Ofgem has devoted much of its attention in recent times to working with stakeholders to track the drivers behind wholesale price increases. In the latter part of last year it was focused on ensuring that any lag in the reduction of prices to consumers was the product of suppliers' responsible purchasing strategies and not evidence that retail competition was stalling.

We worked with customers and suppliers to address real and perceived barriers to switching while warning the industry that we would not hesitate to deploy Competition powers to tackle any indication of anti-competitive behaviour by the suppliers.

Gas

The downturn in energy retail prices – like the rises of the previous years – stemmed from changes in the wholesale gas market.

Ofgem worked with all parties across the supply chain to help build a robust energy supply and demand outlook for winter 2006-2007. This involved engaging closely with European parties as well in light of the evolving supply picture in GB.

New sources of gas

New pipelines carrying gas into the UK were landed in winter 2006-2007 and an existing interconnector was upgraded. Added to this were new facilities to bring liquefied natural gas (LNG) into the UK. Combined, these new facilities promised to add more than 150 million cubic metres of gas a day to the UK's import capacity – double the capacity in place at the start of the year and during the period of high prices.

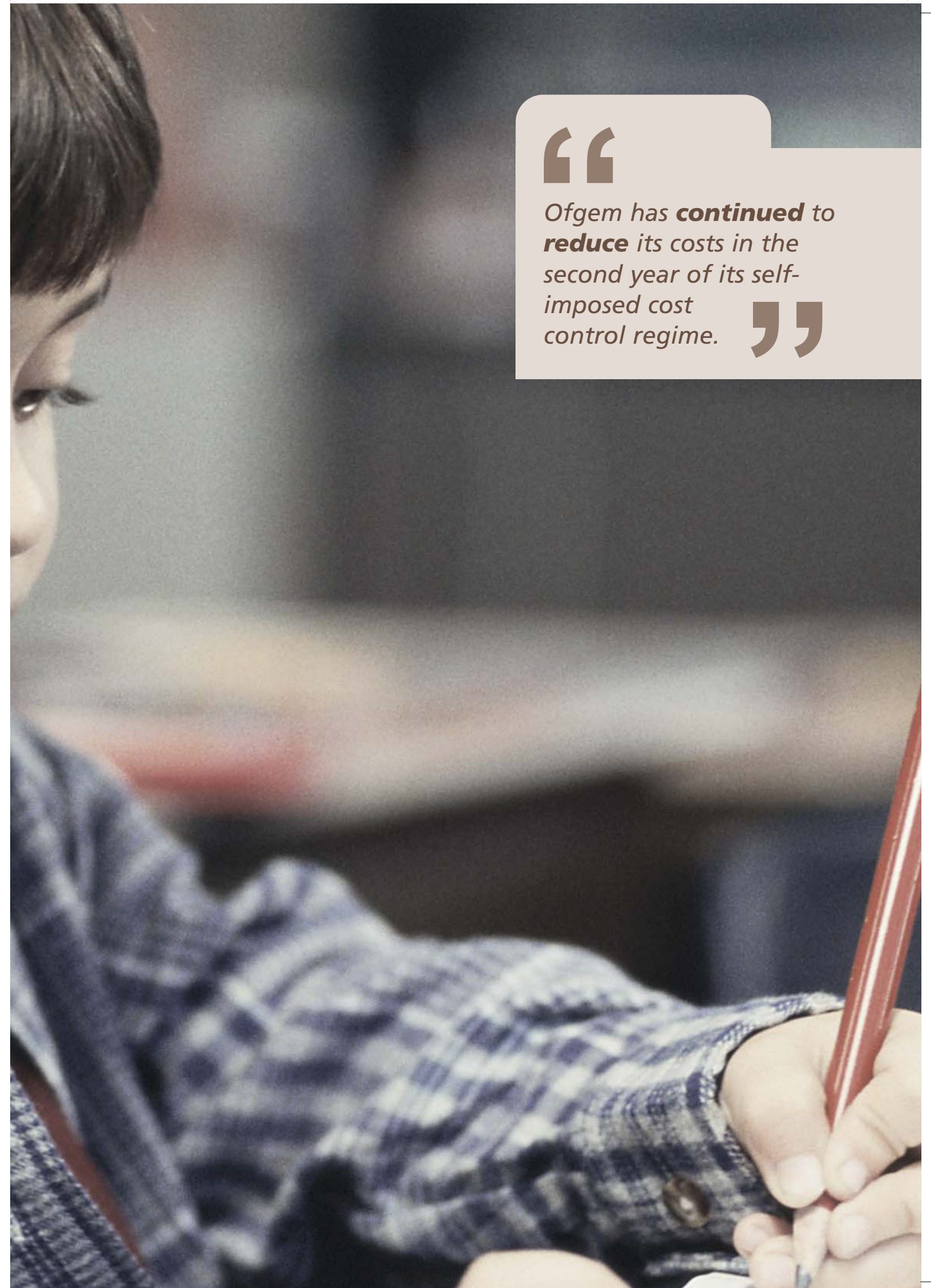
This growth in diversity addressed one of the key issues that fuelled the growth in wholesale prices – the beginning of the fall away of the UK's self-sufficiency in gas supply as North Sea production passed its peak and started to decline. The fact that this decline was more rapid than anticipated exacerbated the impact it had on prices. The competitive market in the UK succeeded in attracting the investment to bring in new and varied sources – investment totalling some £10 billion.

In a vital development to ensure UK consumers gained the full value of the new infrastructure coming into the UK, Ofgem accepted a proposal from consumer watchdog Energywatch to amend the market to increase the amount of information available to industrial consumers on supplies of gas from offshore sources.

“

*Ofgem has **continued** to **reduce** its costs in the second year of its self-imposed cost control regime.* ”

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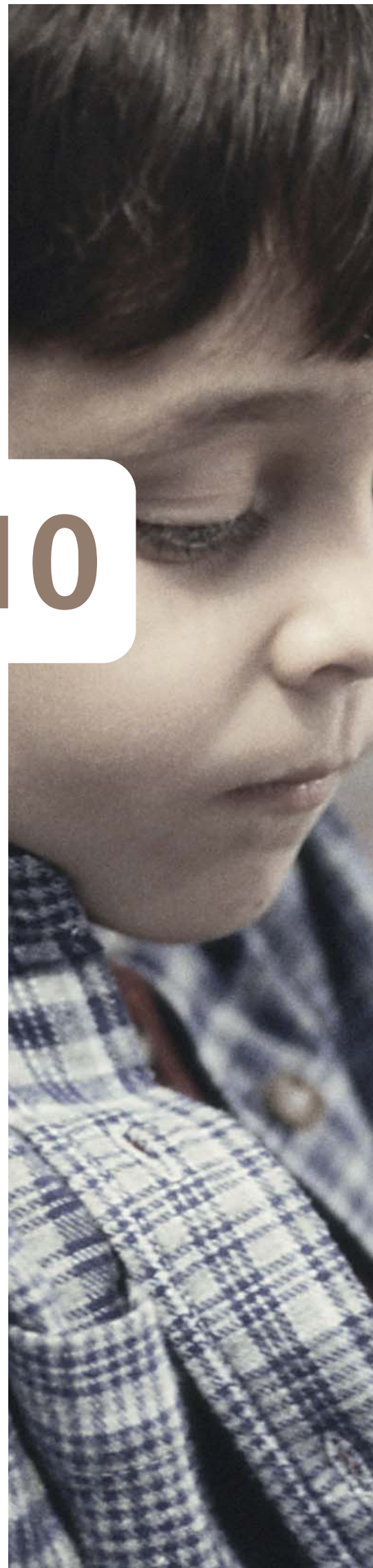


Better regulation

10

Key achievements for 2006-2007

- » Continued to outperform our self-imposed cost reduction regime
- » 91 per cent of deliverables met in the year
- » Reviewed the supply licence conditions
- » New agreement on commercial arrangements for use of electricity distribution networks



Our acceptance of the Uniform Network Code modification proposal was opposed by many gas producers and importers but Ofgem recognised that lack of transparency caused undue problems for customers, traders and suppliers.

The move demonstrated Ofgem's will to see greater transparency in energy markets across Europe.

Winter prices


National Grid's initial outlook in March 2007 on energy supplies for the coming winter indicated that investment in new gas supplies should continue to ease the gas supply situation. But Ofgem has warned against complacency and pressed UK and European gas suppliers to ensure they supply National Grid with accurate information about available supplies for the coming winter. Ofgem has warned too against complacency on prices. Prices were falling at the beginning of 2007 but forward wholesale prices continue to be firm with uncertainties over, for example, weather and information on gas flows.

Electricity

New cash-out arrangements

Ofgem began work with the industry to review aspects of the cash-out arrangements in electricity. These arrangements are designed to ensure the cost of keeping the network in electrical balance is met by generators and users who create the imbalances. The cash-out prices are those paid by market players who create imbalance on the electricity system.

As part of this work Ofgem commissioned two industry experts to report on cash-out arrangements to drive forward industry debate on the issue.



“ **Investment in innovation has been raised to match levels seen in the 1990s.** ”

Helping to tackle fuel poverty

Our research into prepayment meter (PPM) customers showed that, were they to switch supplier, considerable savings were available on this payment method. But many were missing out, particularly those who had never changed supplier. Many felt they lacked information on what was available.

We passed on these findings through our national Energysmart campaign and urged PPM customers to look for better deals.

Along with DTI and other stakeholders we continued to fund the Centre for Sustainable Energy with Bristol University, to update its Fuel Poverty Indicator which predicts levels of fuel poverty regionally across England. It was launched in May 2007.

Ofgem has also worked throughout the year to encourage best practice among energy suppliers, to address fuel poverty and help vulnerable customers.

Supply licence review

Ofgem's review of the licences of the energy supply companies (see page 17) paid particular attention to the needs of vulnerable customers. We worked closely with consumer groups representing vulnerable customers in developing our proposals to ensure that the licence condition amendments were proportionate.

The revised supply licence conditions will be clearer and easier to understand.

Additional protection has been provided through the requirement for timely recalibration of token pre-payment meters and a ban on debt blocking where the debt results from a failure to recalibrate.

Further to this we have introduced a requirement for information to be sent to all customers on gas safety. The requirement for free gas safety checks has been made subject to a means test but the eligibility group has been extended to include families with young children.

Energy efficiency measures

The Government's Energy Efficiency Commitment (EEC) requires energy suppliers to improve energy efficiency among their customers. It is administered by Ofgem. To date it has supported the installation of more than three million major insulation measures in British households. Roughly 1.7 million of those helped were on low incomes. Energy suppliers have worked with social housing providers and charities to ensure that those most in need are targeted for help.

Under the EEC suppliers provide, for example, cavity wall insulation, energy-efficient boilers and energy saving light bulbs to help households reduce their wastage of energy and potentially cut carbon emissions.

Introduction

Ofgem takes forward its work to help eliminate fuel poverty and protect vulnerable customers through regulation, encouraging best practice, influencing the wider debate and providing information direct to customers.

Over the past three years increases in global energy prices have brought steep rises in energy bills which have increased the numbers of households in fuel poverty. This came after nearly a decade of decline in 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, those living on low incomes or in rural areas. We have put pressure on industry to reduce debt and disconnection and encouraged the development of special tariffs and services for vulnerable customers.

Winter Initiative

In winter 2006-2007 our Social Action Strategy Group led a pilot exercise using Department of Work and Pensions data to send a targeted mailer to nearly 100,000 pensioners encouraging them to take up energy efficiency measures, benefit checks and tariff advice.

The success of this Winter Initiative has led Government to commit, as part of the Energy White Paper, to looking at legislation to facilitate information provision of this sort, with appropriate safeguards.

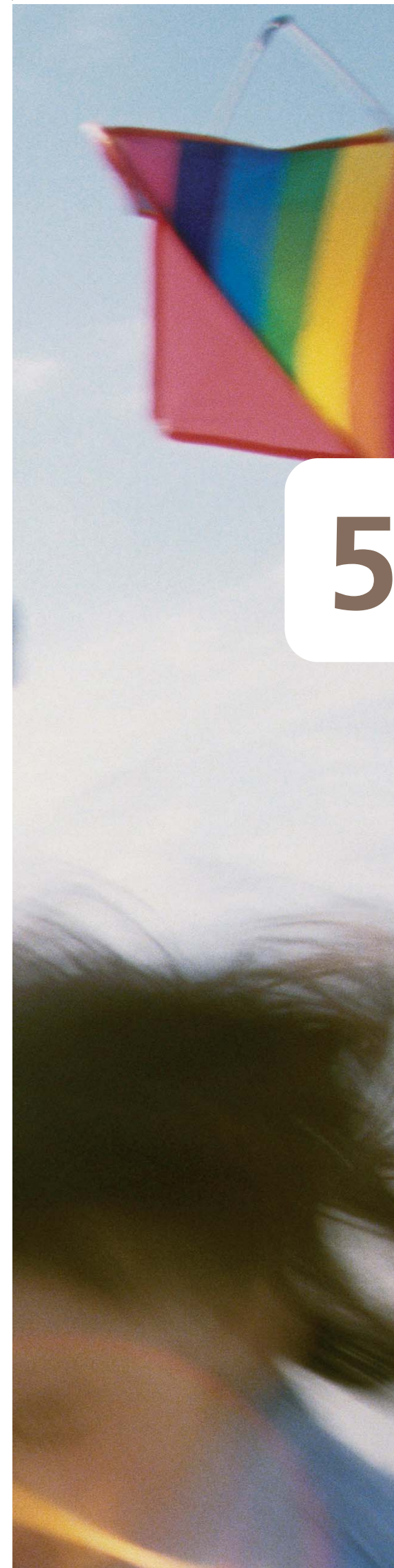
The initiative followed a proposal from Government in its Energy Review to target help for the winter 2006-2007 on pensioners over 70 on pension credit. Ofgem has maintained a call for a concerted approach to tackling fuel poverty with Government, suppliers and third parties working together to target help where it is most needed.

Social Action Strategy

We are in the second year of our five-year Social Action Strategy based on encouraging greater co-ordination of government, industry as well as consumer representatives and the voluntary sector to tackle the combination of low income, poor housing and high energy prices that create fuel poverty.

Some of Ofgem's key contributions have been through research, reporting and promoting best practice – all key elements of our Social Action Strategy.

Our research into the energy industry's work on Corporate Social Responsibility (CSR) revealed that consumer awareness of these measures was low. We have set about reviewing suppliers' CSR initiatives against a new framework which will report on suppliers' performance in this area. This will inform the Government in its assessment of the need for legislation in relation to social tariffs.



5

Regulating network monopolies

Key achievements for 2006-2007

- » Completed the Transmission Price Control Review for 2007-2012
- » Completed a one-year Gas Distribution Price Control Review and started work on the first full review
- » Reformed commercial arrangements in electricity distribution
- » Progressed offshore wind transmission licensing regime
- » Recognised service improvements for vulnerable customers via the discretionary award scheme
- » Took forward distributed generation arrangements

Introduction

In sections of the industry where competition is not a realistic option Ofgem protects consumers' interests by imposing controls and incentives. This applies to the monopoly businesses that run the networks of pipes and wires that carry gas and electricity to homes and businesses. In this way we ensure that homes and businesses get the best value for money and reliable supplies.

Transmission

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

Transmission Price Control Review

Our price control proposals for transmission networks were finalised at the end of 2006 to apply from April 2007. The price control review had to address some significant shifts in the landscape of energy transmission in the UK.

The review included radical moves to boost the much-needed investment in infrastructure to renew ageing assets and to support the growth in gas and electricity production capacity.

We authorised more than £5 billion in investment in Britain's transmission networks for the price control period 2007-2012 – an increase of 100 per cent on the previous period. This capital spending is earmarked for maintaining the networks' high standards of performance and reliability and upgrading to meet new demands on the system – particularly those coming from growth in wind power and other renewable generation technologies.

The escalation in the amount of gas imported into the UK rather than produced from the North Sea, along with the need to build new electricity generation using wind power and other renewable technologies, is presenting the energy transportation businesses with new and challenging demands.

Among the headline elements of the price review were capital expenditure allowances of:

- ▶ £2.997 billion for National Grid Electricity Transmission;
- ▶ £608 million for ScottishPower Transmission;
- ▶ £181 million for Scottish Hydro-Electric Transmission; and
- ▶ £825 million for National Grid Gas NTS.

Added to this total of £4.6 billion was £530 million previously agreed investment to connect new low-emission generation projects in Scotland making a final total of more than £5.1 billion. The spending allowance in Scotland was made by acting outside the price review structure. Other examples of flexible thinking in the network price controls included:

- ▶ new protection against a substantial shortfall in investment against company plans under which a company's price controls will be reconsidered if

9

Helping to tackle fuel poverty

Key achievements for 2006-2007

- » Led Winter Initiative targeting 100,000 pensioner households
- » Improved protection for vulnerable customers through the Supply Licence Review
- » Produced research and information to help consumers with energy choices





“ We have a specific duty to have regard to the interests of **vulnerable customers**, those who are disabled or chronically sick, older people, those living on low incomes or in rural areas. ”

investment falls more than 20 per cent below allowances;

- ▶ incentives to invest in research and development targeted at environmental improvement (see page 37); and
- ▶ new flexibility mechanisms in the price controls to enable the companies' revenue allowances to adjust either way in response to network users' needs. This was to address the uncertainty over which renewable projects will go ahead or be completed during the five-year period. At the high end of estimates these mechanisms could add £1 billion to transmission company allowances.

Gas offtake reform

Reform of the regime governing the offtake of gas from the transmission network by distribution networks and large industrial users, including gas-fired power stations, was a key condition for consent of the sale by National Grid of four of its gas distribution networks (GDNs) in 2005.

Reform proposals were intended to indicate to National Grid when and where to invest and to allow fair access to those wanting to use the networks.

In June 2005, Ofgem's governing Authority postponed implementation of these reforms until 2007 to give time for further consultation in conjunction with the transmission price control review. During 2006-2007, proposals for reform were introduced by National Grid and a number of alternatives were proposed by the industry. The Authority's decision to approve the National Grid proposals is currently the subject of an appeal to the Competition Commission.

Offshore transmission licensing regime

After consultation with stakeholders carried out jointly by Ofgem and the DTI, we and the Government decided that Britain's transmission network owners should compete with others to build, own and maintain the links that will connect planned offshore wind farms to the mainland grid. These links will be crucial for the UK to achieve its renewable energy objectives and to add to the security of UK energy supplies for the future.

Distribution

Distribution is the transportation of gas or electricity from the national transmission grids into the regional branches and on to customers.

Gas

First separate distribution price controls

In the past we have set a single price control for the national gas transmission and distribution networks. However, the sale by National Grid Gas in 2005 of four of the eight gas distribution networks (GDNs) has enabled us to begin to apply regulation based on comparisons of the performance of each GDN.

In 2006-2007 we developed a one-year extension of the gas distribution review to separate the timing of the full five-yearly review from the gas transmission review. We also started work on the next five-year control, which will take effect in April 2008.

The main benefits of being able to compare GDN performances will become evident in future reviews when we can see how the companies perform over a longer period of separate ownership. But we are confident that we will be able to secure some tangible benefits for customers in the current review.

Electricity

Incentives to innovate

Under the 2005-2010 price controls for the electricity distribution companies Ofgem introduced ground-breaking incentives for research and development and innovation in the connection of generation.

In 2007 we agreed to extend these measures for a further five years so that companies initiating new projects can be confident that the incentives will continue to apply.

Under the Innovation Funding Incentive (IFI) scheme the companies can pass through to customers most of the cost of research and development projects that meet criteria set by Ofgem.

“ We authorised more than **£5 billion** in investment in Britain's transmission networks for the price control period 2007-2012 – an increase of 100 per cent on the previous period. ”

Registered Power Zones (RPZ) provide the companies with a specific incentive for trialling new and innovative methods of connecting new generators – principally renewables – to their networks.

The two incentives together are potentially worth some £90 million to the companies in additional allowed expenditure and revenue over five years. The extension introduced last year increased their combined value to £180 million over a ten-year period. Investment in innovation has been raised to match levels seen in the 1990s.

Connection standards

Ofgem introduced tighter requirements on network companies to meet deadlines and service standards when carrying out connection work. The companies are obliged to meet 90 per cent targets in three key areas – if they fail in this they may face enforcement action by the regulator. The move has strengthened the position of customers seeking large connections by making it easier for independent connection providers to compete with the network companies.

Reform of commercial arrangements in electricity distribution

The Distribution Connection Use of System Agreement took effect in October 2006. It was the culmination of more than four years’ work to reduce some 400 separate agreements that had gathered since the power industry’s privatisation.

Distributed generation

Electricity generators connected to the distribution networks rather than the transmission system are called distributed generation. This type of generation can bring environmental benefits because the electricity it produces is generally used locally which cuts down the need for transmission lines and reduces power losses that go with long-distance transmission of electricity.

Working with the DTI, Ofgem reviewed the barriers hindering the growth of distributed generation. The substantive study uncovered a number of key obstacles and looked at options for addressing them. Barriers included: poor rewards for selling power onto the network; planning regime difficulties; and the existing centralised structure of the electricity industry.

Running parallel to this review of distributed generation has been work on the market for rooftop wind power and other household-scale generation – so-called microgeneration – itself a form of distributed generation (see page 17).

Ofgem approved a new, more transparent method for distribution company charges for the use of their networks. This model, which improves the extent to which the charges reflect the costs incurred by the companies, rewards more accurately distributed generation for its network benefits.

Discretionary Award Scheme

Now in its second year, Ofgem’s discretionary award scheme rewards distribution network operators for measures they take beyond their obligations to customers.

The second set of outcomes from the scheme improved on the first in demonstrating sharing and adoption of best practice. We are planning to extend the scheme into gas distribution.

The scheme was set up by Ofgem as part of the electricity distribution price controls for 2005-2010. The electricity distribution network operators submit details of measures where they have exceeded their licence requirements to help vulnerable customers who, for example, may depend on electricity supplies to keep medical equipment running. In every application the network companies demonstrated innovation and best practice in priority customer care.

Network innovation incentives

We extended the duration of incentive schemes for innovation in electricity distribution networks and doubled their potential value to £180 million (see page 23). And in our review of the transmission price controls we introduced, a similar scheme to encourage innovation in projects aimed at achieving environmental benefits.

These Innovation Funding Incentives allowed companies to invest up to 0.5 per cent of their revenue in innovation. And we created a separate incentive for the electricity transmission networks to reduce leakage from network equipment of sulphur hexafluoride – a potent greenhouse gas.

Environmental programmes

Ofgem administers, on behalf of Government, a number of crucial components of its Climate Change Programme including the Renewables Obligation and the Energy Efficiency Commitment.

Renewables Obligation

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

The obligation was designed so the target increases each year from 3 per cent at its instigation in 2002 to 15.4 per cent in 2015-2016. The target continues at this level until 2027, although Government is consulting on a proposal to increase this to 20 per cent. The target for 2006-2007 was 6.7 per cent.

Over 15 million Renewables Obligation Certificates were issued during 2006-2007, compared with just over 14 million in 2005-2006.

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 in 2006-2007. This reaches 6.3 per cent in 2012-2013 and stays at this level until 2027.

Climate Change Levy

Ofgem continued to administer the Climate Change Levy (CCL) exemption for renewables. 2006-2007 was the sixth year of the CCL exemption and over 20 million Renewables Levy Exemption Certificates (LECs) were issued (up to January 2007).

Since April 2003, the exemption from CCL for direct supplies of combined heat and power (CHP) generated electricity from sources designated as good quality was extended to include indirect supplies – those supplies exported to the grid. We issued nearly 25 million CHP LECs in 2006-2007 to complying schemes, and to date we have issued over 88 million CHP LECs to these stations.

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 Government, the Energy Efficiency Commitment (EEC) programme. The EEC obliges domestic electricity and gas suppliers to deliver energy savings by improving energy efficiency among domestic consumers. Half of the energy savings must come from priority customers who receive benefits or certain tax credits.

Under the Energy Efficiency Commitment suppliers installed, or provided, energy efficiency measures which would result in energy savings of 47 TWh, or 36 per cent of the total target for 2005-2008.

During 2006-2007, we provided expert advice to Defra on the shape of the third phase of the EEC (since renamed the Carbon Emissions Reduction Target). This programme will cover 2008-2011.

“ We extended the duration of incentive schemes for innovation in electricity distribution networks and doubled their potential value. ”

Introduction

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.

Ofgem's goal is to assist the gas and electricity sector to achieve environmental improvements as efficiently as possible so customers pay no more than necessary. We encourage the development of market mechanisms to put a price on carbon emissions and to create an incentive to reduce them. We also promote energy efficiency and administer a range of Government environmental schemes to develop low-emission generation and install energy efficiency measures in the home.

First sustainable development report

Ofgem is responding to the rising tide of environmental and social issues that affect the energy sector. A marker of the extent of our efforts on these issues – which form the core of sustainability – was the publication of our first Sustainable Development annual report.

In it we showed Ofgem's direct input into boosting the prospects for wind power and other renewable energy – £5.1 billion of increased investment allowances for electricity and gas transmission companies which included money for connecting new renewable plant.

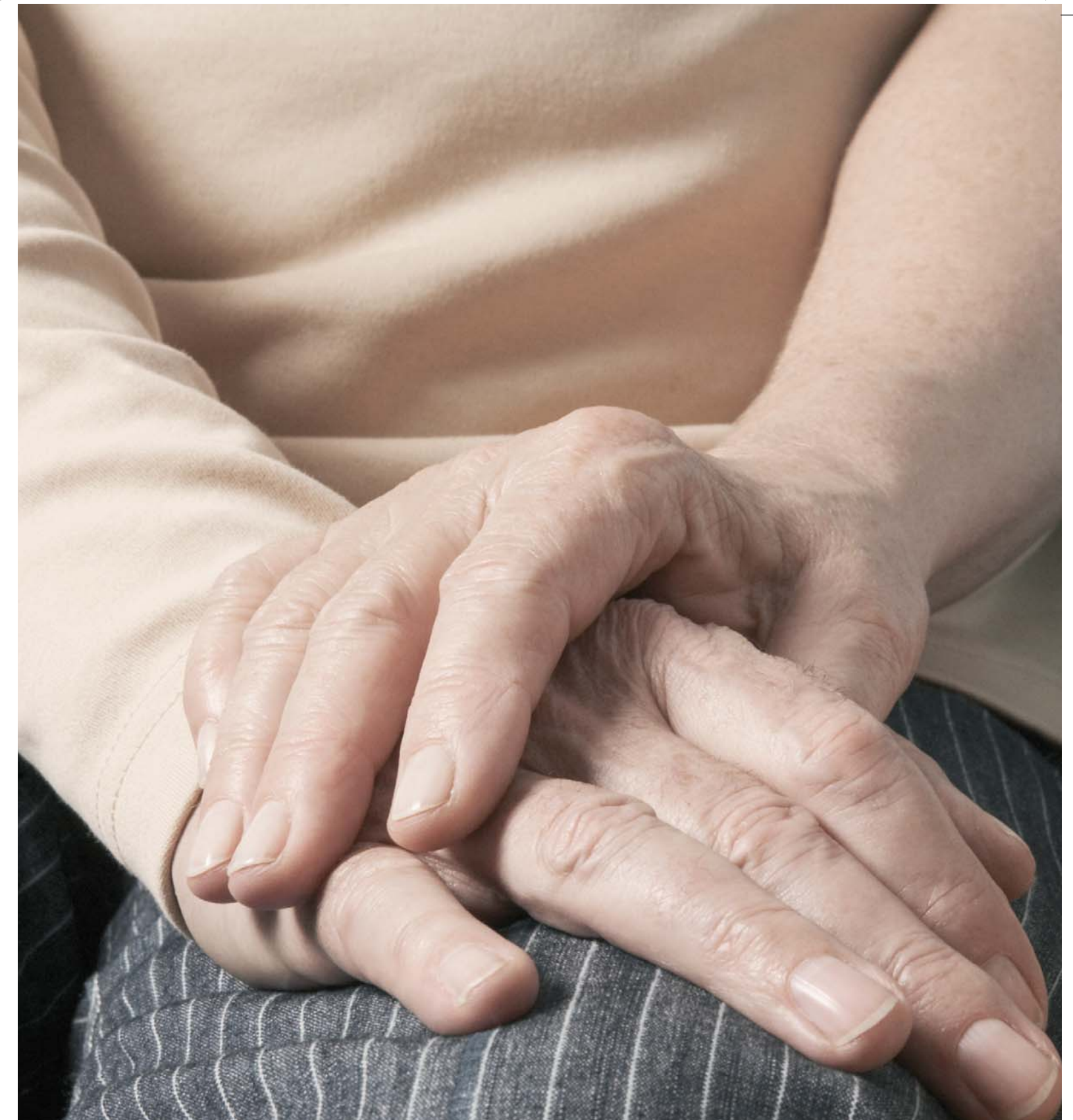
The first phase of the government's Energy Efficiency Commitment – also administered by Ofgem – had helped some six million low-income families to install energy saving measures in their homes. But the report showed that there was more to do, particularly for the fuel poor consumers for whom energy takes up more than 10 per cent of their cost of living.

In the report we sought suggestions from stakeholders on what additional action Ofgem, the Government and other bodies should take to protect the interests of energy consumers now and in the future.

Our Sustainable Development Committee, chaired by Gas and Electricity Markets Authority member Dr Robin Bidwell, informs our work and advises the Authority on matters relating to sustainability.

Organisational change

Responding to the shifting nature of UK and other EU markets Ofgem reorganised its markets division. The changes deploy Ofgem's resources better given its stronger focus on developing competitive and sustainable energy markets in the UK and in the rest of Europe.



“ The network companies demonstrated innovation and best practice in **priority customer care.** ”

Helping to protect the security of Britain's energy supplies

Key achievements for 2006-2007

- » Transmission Price Control Review
- » Long-term scenario analysis
- » Winter outlook
- » Continued to play a pivotal role in developing energy emergency arrangements

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Critical to security of supply is market transparency.

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Helping to protect the environment

8

Key achievements for 2006-2007

- » Major investment in transmission and distribution networks to facilitate renewable generation
- » Progress in releasing the potential of smart metering and microgeneration
- » Ofgem's first Sustainable Development annual report
- » Over 15 million Renewables Obligation Certificates were issued during 2006-2007, compared with just over 14 million in 2005-2006
- » Under the Energy Efficiency Commitment suppliers installed, or provided, energy efficiency measures which would result in energy savings of 47 TWh, or 36 per cent of the total target

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We encourage the development of market mechanisms to put a price on carbon emissions and to create an incentive to reduce them.

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Introduction

The need to create conditions to ensure that the UK has a secure supply of energy underpins Ofgem's every move. The foundations of our work in this are competitive wholesale and retail markets and regulation of network monopolies to ensure adequate investment in energy transportation infrastructure.

Transmission price control review

In our review of the controls on revenue and expenditure of the gas and electricity transmission companies we more than doubled the investment the companies are allowed to make over the next five years (see page 22). This increased expenditure allowances to meet the need to renew ageing elements of the energy networks and to accommodate the expected growth in renewable generation.

Long-term scenario analysis

Ofgem committed in its Corporate Plan to give priority to long-term investment and security of supply through our work with the government on market monitoring and our plans to produce new energy scenarios.

Market scenarios

Ofgem was a key player in the Joint Energy Security of Supply working group and will play a similarly important role in its successor, the new Energy Markets Outlook (EMO) programme, which will be run jointly by Ofgem and Government.

The EMO will generate scenarios to fuel debate and analysis of the UK's energy policy. It will look at potential developments in gas and electricity markets over the next 15 years to provide industry with credible long-term market scenarios without prejudging policy. It will be an aid to strategic thinking but it will neither prescribe strategies for the regulated companies nor provide forecasts.

Network scenarios

The main objective of Ofgem's long-term Energy Network Scenarios (LENS) exercise is to ensure that the flexible five-year allowances set in price control periods fit with plausible longer term outlooks. Ofgem plans to facilitate the development of a range of future scenarios for 2050 as a platform for debate among stakeholders on longer term network development issues.

This approach will enable stakeholders to look much further into the future than has been possible through price control reviews. But, as with EMO, it will not aim to make forecasts.

Gas

The Gas Regional Initiatives involve 14 European Union states with the UK in a group alongside the Netherlands, Belgium and France. They involve relevant stakeholders including regulators, market participants, consumers and governments.

Together with the energy regulators from those member states Ofgem is looking at the chief considerations for the development of competition including: congestion management for interconnecting networks, upgrading access to each other's markets, improving wholesale market transparency and the development of liquefied natural gas trading hubs.

Electricity

Under an initiative aiming to tackle barriers to electricity market integration at grass roots level, Ofgem and the regulators from France, the Republic of Ireland and Northern Ireland launched a consultation highlighting key issues hindering liberalisation. These mirrored the issues in the gas market.

Introduction

With the UK's greater exposure to markets in the rest of the European Union as it moves to being a net importer of gas, the impact of European energy policy is becoming highly influential on the UK market and consequently on Ofgem.

We play a central role in European Union energy policy development by leading workstreams, chairing the environment taskforce and through Sir John Mogg's chairmanship of the European Regulators' Group for Electricity and Gas (ERGEG) and presidency of the Council of European Energy Regulators.

European policy

At the start of the year the European Commission published its Strategic Energy Review and the results of an inquiry into EU energy markets. The key outcome was the promise of legislative pressure on the dominant vertically integrated energy companies to separate production and transportation operations – so-called unbundling. Ofgem had been central in the drive for such reform and has urged the Commission to see its objective to completion.

At the start of 2007 the Commission published the findings from its Strategic Energy Review and its sector inquiry which had both been assisted by Ofgem. The Commission made clear its focus on the need to separate the production and transportation business of Europe's dominant vertically integrated energy companies.

Our close tie with Brussels on this and other issues was demonstrated when Competition Commissioner Neelie Kroes delivered a speech at one of Ofgem's high-level "Powering the Energy Debate" seminars and emphasised the Commission's commitment to unbundling as key to market liberalisation.

Regional initiatives

Ofgem has supported a programme of regional European initiatives in gas and electricity markets that seeks to remove trade barriers so competitive markets can develop in each region.

The initiatives were instigated by ERGEG to galvanise change across the European Union. Under these initiatives, regions work together before merging into a single market across the Union. These initiatives are being taken forward as voluntary measures with 14 member states taking part.

Emergency arrangements

Ofgem drove the creation of the Energy Emergencies Executive which oversees emergency planning. We were, and remain, integral in the development of emergency plans to prepare the UK for possible, but unlikely, catastrophic loss of energy supplies.

The emergency arrangements have been tested through simulation exercises with industry, Government and consumer groups also taking part. A project to review the plans for recovery from the unlikely event of a nation-wide loss of power was completed in May 2006.

Europe

Critical to security of supply is market transparency and Ofgem has worked with significant impact to open up access to information from other European markets though our work in Europe and our contributions to the European Commission's investigation into energy markets.



“ Ofgem has **supported**
a programme of regional
European initiatives in gas and
electricity markets that seek
to remove trade barriers. ”

7 Leading voice in Europe

Key achievements for 2006-2007

- » Exerted a central influence on European energy policy manifested in the Commission's stepped-up drive to market liberalisation
- » Led the move toward market integration through the launch of initiatives to develop regional markets in gas and electricity
- » Key supporter of the Commission's move towards sustainable energy markets and chairing the European task force bringing together the consideration of environmental issues in energy policy