

# **Final Impact Assessment for Proposals for Implementation of the EU Third Energy Market Package (Over-arching IA)**



# Introduction

Since the mid-1990s, the European Union (EU) has put in place legislation that aims to support the creation of a single energy market within the EU by introducing competition and removing barriers to cross-border trade. This gradual transition has been progressed to date through two previous packages of legislation. A third internal energy market package (the 'Third Package') was adopted in July 2009 and must be transposed into national law by all Member States by March 2011<sup>1</sup>.

The Third Package consists of two Directives – one concerning the internal market in natural gas and one concerning the internal market in electricity – and three Regulations – one on conditions for access to the network for cross-border exchanges in electricity, one on conditions for access to the natural gas transmission networks and access to gas infrastructure and one establishing a new Agency for the Cooperation of Energy Regulators (ACER).

## Intended Effects

The Third Package has been designed to increase competition in many areas of the energy market, through creating a more liberalised market with enhanced consumer protection and improved functioning of energy markets. This should lead to greater security of supply, and more competitive prices and services.

- The main objective of the Third Package is to create a fully liberalised market by ensuring strong consumer protection measures are in place;
- a fully independent regulator; and
- well developed network ownership arrangements

In those areas where GB is required to take more action to ensure compliance, the costs and benefits from implementation of the Third Package will be more substantial. In other areas, we believe costs and benefits from GB's implementation will be limited as GB is compliant in many areas but significant benefits could derive to GB from ensuring the compliance of other Member States. These benefits will come through the promotion of cross-border trade and the lowering of barriers to market entry to additional players across the EU, which could result in lower prices for GB energy imports.

We believe that the Package will have an overall positive effect on the economy, by creating a level playing field across Europe on which UK-based companies can operate. Taken together, the measures will contribute to enhancing consumer protection, promoting competitive energy

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<sup>1</sup> Undertakings affected by the transmission network unbundling requirements of the Third Package will have an extra year after the requirements have been transposed into law, to comply, and therefore will have until 3 March 2012.

markets, increasing security of supply, reducing regulatory uncertainty, and increasing the autonomy of the National Regulatory Authority.

For most provisions of the Third Package, our final proposal for implementation represents minimum compliance, which we believe will impose a minimal burden on business while maximising the benefits of the Third Package for the UK. This option is preferred as we wish to ensure that UK business is not placed at a disadvantage in the internal market as a result of these measures. Our final proposal for implementing a licence modification appeals system to meet Third Package requirements does exceed the minimum requirements of the Directive, but we believe that our preferred option will deliver a coherent regulatory framework leading to improved decision making and greater regulatory certainty.

## Measures

This Impact Assessment (IA) attempts to capture, at a high level, the benefits and costs to GB of the final proposals for implementation of the Third Package.

All of the key measures within which GB is currently non-compliant have been examined in individual Impact Assessments included in this document. Each Impact Assessment (IA) discusses the final proposals for implementation, rationale and costs and benefits in more detail, taking into account evidence received during the consultation process. These have also been summarised at the end of this Impact Assessment.

In many cases, individual measures contribute to more than one policy objective. For the purposes of this Impact Assessment, however, we have brigaded individual measures under the primary policy objective that they target.

### Consumer Switching

The relevant measure requires suppliers of electricity and gas to ensure that where a customer, while respecting contractual conditions, wishes to change supplier, the change is effected within three weeks.

This measure is designed to improve the switching process for consumers by reducing the time it takes to switch. High levels of switching are associated with greater competition in the market, which should result in lower prices, increased product ranges for consumers, and increased innovation from suppliers.

Currently in the UK, it takes an average of between 4-6 weeks to switch electricity, and slightly longer to switch gas. This new measure will give consumers a legal right to switch within three weeks unless there are extenuating circumstances; for example, where the customer has not given the supplier adequate or accurate data to enable the transfer. The 3 weeks will start from the end of any cooling off period, which should not exceed 14 calendar days consumers will be given to cancel the contract. Energy suppliers will be required to make improvements to their systems and processes to ensure that as many people as possible are switched within 3 weeks. Ofgem will provide relevant guidance to suppliers about proportionate changes they need to make to their IT systems.

In practice the UK has already effective switching arrangements. This measure will reduce the time taken to switch slightly and therefore we expect the benefits to consumers to be limited.

A brief summary of the costs and benefits of the preferred option is set out in Table 1.

<b>Table 1: Consumer Switching</b>	
<b>Costs</b>	<b>Benefits</b>
<p>There will be costs to suppliers from making changes to their systems and processes. This is difficult to quantify at this stage as work would need to be done to review the scale of upgrades needed.</p> <p>In addition, there will be a one-off administrative cost to energy suppliers in order to amend their standard terms and conditions.</p>	<p>There will be a direct benefit to switching customers who take advantage of their new gas/electricity tariff in a reduced time. However, we recognise that this, at least in some part, represents a transfer from suppliers to consumers.</p> <p>There may be an indirect effect as quicker switching could lead to greater competition in the market.</p>

## Consumer Information

The measures include a requirement on suppliers to ensure consumers are informed about their actual consumption and costs and can request that data is provided to other suppliers; a requirement for suppliers to inform customers about the means of dispute settlement available to them; an energy consumer checklist to provide consumers with information about their rights and other issues that may affect them. Finally, there is a requirement on suppliers to keep certain data at the disposal of the national regulatory authority.

These measures are designed to improve the quality and quantity of information available to consumers on both their individual consumption, their rights, and industry processes. Greater transparency and consumer awareness is a driver of competitive energy supply markets. In the long term these measures may enable consumers to better act as a competitive constraint on suppliers' pricing and provide strong incentives on suppliers to reduce costs, improve service and develop innovative products. However the proposed changes are only expected to have a minimal direct impact on GB consumers as these measures are already in place to a large extent. The costs on suppliers may be higher as they are required to collect and provide extra data.

A brief summary of the costs and benefits of the preferred option is set out in Table 2.

**Table 2: Consumer Information**

<b>Costs</b>	<b>Benefits</b>
<p>This measure imposes a small one-off cost to energy suppliers associated with changing promotional material and sending out the concise version of the Consumer Checklist. There may be larger costs associated with data collection and an increased administrative burden associated with the provision of information to regulatory bodies.</p> <p>There is also a one-off cost to Consumer Focus<sup>2</sup> for compiling and keeping the checklist under review.</p>	<p>There is a direct benefit to consumers who will be able to use their consumption information to take advantage of more suitable tariffs and improve their services as a result of access to information about dispute settlement mechanisms.</p>

## Transmission and Distribution Networks

The measures introduce new requirements for full ownership unbundling of transmission, and introduce greater monitoring powers around the continued legal unbundling for distribution.

The network-related objectives of the Third Package are designed to improve competition through better regulation, unbundling and reducing asymmetric information, and improving security of supply by strengthening the incentives for sufficient investment in transmission and distribution capacities.

However, in the area of transmission and distribution networks, the GB gas and electricity arrangements are to a large degree already compliant with the Third Package. One of the key areas we need to address, however, is to provide the legislative framework within which Ofgem can certify transmission systems as meeting the requirements of ownership unbundling. We do not expect the cost of this measure to be significant.

A brief summary of the costs and benefits of the preferred option is set out in Table 3.

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<sup>2</sup> The Government intends to consult on the future of consumer bodies. Should this consultation result in changes to the role of status of Consumer Focus, we would expect this work to be carried out by any successor body.

**Table 3: Transmission and Distribution Networks**

<b>Costs</b>	<b>Benefits</b>
<p>This measure imposes legal and administration costs associated with legislation changes and licence modifications to ensure compliance with TSO and DSO unbundling requirements for both Ofgem and the TSOs. There will be administration and legal costs to Ofgem and TSOs associated with the TSO certification process, particularly where derogations are requested. There may be additional costs associated with strengthened information gathering powers for Ofgem enforcement of DSO unbundling articles. There may also be costs to DSOs of ensuring independence of compliance officer.</p>	<p>GB is already compliant to a large degree and we would therefore expect the benefits to be minimal. Full compliance could lead to small gains in terms of more efficient networks (less congestion, more investment), decreased market concentration leading to lower energy prices for consumers, and higher innovation in the energy sector. The likely extent of these benefits is small, as under 10% of GB transmission assets are not already fully ownership unbundled and the European Commission acknowledges that even then the GB system exemptions function reasonably well.</p>

### Citiworks Ruling: Third Party Access to Licence Exempt Networks

Following the European Court of Justice (ECJ) ruling on the Citiworks case in May 2008, there is now a requirement to provide for third party access in respect of all transmission and distribution systems. This also applies to licence exempt electricity and gas distribution networks which are required to offer third party access under the Electricity Directive and the Gas Directive. Closed Distribution Systems (licence exempt networks) will continue to be required to provide third party access under the EU's Third Package.

The policy objective is to ensure third party access to licence exempt energy distribution networks. This will ensure energy customers benefit from competition in the energy supply market and ensures the compliance of the GB electricity market with EU law.

A brief summary of the costs and benefits of this preferred option is set out in Table 4.

**Table 4: Citiworks Ruling: Third Party Access to Licence Exempt Networks**

<b>Costs</b>	<b>Benefits</b>
<p>The main costs associated with providing third party access to these networks are those associated with metering – either meter provision or ‘deemed’ metering. Costs will vary substantially according to the implementation models chosen.</p>	<p>There will be benefits associated with reductions in energy use, where meters are provided.</p> <p>Switching consumers will benefit from lower energy prices. The evidence is ambiguous on the extent to which these benefits are likely to be achieved.</p>

## Gas Storage and LNG Facility Impacts

These measures include a requirement for Storage System Operators (SSOs) to be legally unbundled, for third party access to storage facilities that are technically and / or economically necessary to be strengthened, for all gas storage and LNG operators to be designated, and for more information to be made publically available by gas storage and LNG facility operators.

The measures are intended to have the effect of reducing market power, increasing competition, increasing efficient investment and use of assets, helping to allow gas to flow to where it is needed most, and enhancing security of supply. However, the actual measures are unlikely to have a large impact.

In DECC's consultation on the implementation of the EU Third Package, we considered two options for implementing the key provisions: through the Gas Act 1986 (legislation) or through the introduction of licences for SSOs. The consultation document contained both options. Following the majority view in response to the consultations, DECC has selected to implement the obligations through legislative change.

DECC received little firm evidence in the consultation responses to inform its estimates of the costs and benefits of implementing the Third Package. A qualitative summary of the costs and benefits of the preferred option is set out in Table 5.

**Table 5: Gas Storage and LNG Impacts**

<b>Costs</b>	<b>Benefits</b>
<p>There may be small costs associated with unbundling, some costs associated with reduced economies of scope on vertically integrated firms, and costs associated with additional information provision by LNG and storage facilities.</p> <p>Ofgem may experience small additional costs due to enforcement.</p>	<p>The benefits specifically arising from GB implementing the gas market measures will be: benefits to consumers from more competitive pricing and increased security of supply; benefits to storage users from information transparency and non-discriminatory allocations; and benefits to investors arising from greater regulatory certainty.</p>

## National Regulatory Authority

The Third Package includes a number of measures to enhance the independence, impartiality and transparency of the national regulatory authorities. These measures include requirements on Member States to ensure that staff employed by national regulators are able to act independently of market interest. Compared to the Second Package, the Directives require an expansion to the regulator's duties, for example in relation to cross border issues, and a requirement to ensure that they have the necessary powers to carry out their duties.

GB has in place many of the requirements in the Directives in relation to independence and transparency, although some of these requirements do not go far enough (please see section on Licence Modification Appeals below) .

Although it is difficult to put a monetary value on the benefits associated with these measures, we would expect the intangible benefits arising from these measures to be an increase in the integrity of the regulator and a better functioning of the EU internal market. This could lead to better market outcomes and overall reduced costs for consumers.

For the reasons set out above, we expect the actual impact of these measures to be small. A brief summary of the costs and benefits of the preferred option is set out in Table 6.

**Table 6: National Regulatory Authority**

<b>Costs</b>	<b>Benefits</b>
<p>These measures will increase Ofgem’s duties, a number of which are monitoring. There may also be an increase in the administrative costs Ofgem faces, for example through an obligation to report to the Commission and ACER (the Agency for the Co-operation of European Regulators) on its activities. Overall we expect the costs associated with individual measures to be small.</p>	<p>We would expect the intangible benefits arising from these measures to increase the integrity and workings of the regulator, as well as the consistency of regulation in Europe. This should lead to better market outcomes for both industry and consumers.</p>

## Licence Modification Appeals

As referred to above, the Third Package gives the National Regulatory Authority numerous regulatory tasks and stipulates that it must have powers to, amongst other matters: take autonomous decisions; implement binding decisions by the European Commission and ACER; and carry out its regulatory tasks in an efficient and expeditious manner. It also requires that Member States ensure that suitable mechanisms are in place under which a party affected by the decision has a right of appeal. Taken together, the Government considers that these requirements mean that the current process for licence modifications must be amended to enable the regulator to carry out its duties.

Under the current system, Ofgem’s proposed change or introduction of a standard licence condition can be blocked by 20% of the relevant licensees (measured by number of licence holders or market share). If the proposal is blocked then Ofgem can either re-consult on a modified proposal or refer the proposal to the Competition Commission (CC) for a decision. For conditions specific to one licensee, the licensee must agree to the proposal. Failure to reach agreement with that licensee means that if Ofgem wants to impose the change, it must refer its proposal to the CC for a decision. In considering a reference made to it, the CC investigates whether the licence modification operates or may operate against the public interest.

Our preferred option is the introduction of an appeals system which will enable all directly affected licensees (i.e. those holding the class of licence to which the modification decision relates), all materially affected licensees and Consumer Focus (where consumers are materially affected), to appeal all licence decisions to the CC. The CC will have an adjudicatory function (rather than a full investigatory function), but will have the right to review all relevant aspects of the decision under appeal. Under this option, Ofgem will make a licence modification decision (after the current statutory consultation period). If that decision is to modify a licence condition, a directly affected licence holder, another materially affected licence

holder or Consumer Focus (where consumers are materially affected) can, with sufficient grounds, appeal that decision to the CC.

Our final proposal for implementing a licence modification appeals system to meet the Third Package requirements does exceed the minimum requirements of the Directive, in that:

- it applies to all Ofgem licence modifications decisions rather than introducing an appeals system for the implementation of decisions in relation to the regulatory tasks arising from the Third Package only; and
- it extends the right of appeal from directly affected licensees only to other materially affected licensees and Consumer Focus (where consumers are materially affected).

However, we concluded that, were minimum implementation feasible, the resulting costs would be uncertain, and it would likely lead to increased regulatory uncertainty and risk of satellite litigation. In addition, though extending the right of appeals may lead to an increase in the number of appeals (and thereby an increase in costs), we believe that this will deliver a coherent regulatory framework leading to improved decision making and greater regulatory certainty.

A brief summary of the costs and benefits of the preferred option is set out in Table 7.

**Table 7: Implementation of Licence Modification Appeals**

<b>Costs</b>	<b>Benefits</b>
<p>Monetised costs include the one-off set-up cost to the CC, and ongoing costs associated with appeals borne by the CC, Ofgem and business. These latter costs depend on the number of appeals per year.</p> <p>Non-monetised costs include costs associated with interested parties giving evidence at each appeal</p>	<p>Monetised benefits include ongoing cost-savings from avoided licence modification references, to the CC, Ofgem and business.</p> <p>Non-monetised benefits include improved quality of decision making; improved efficiency of decision making; increased fairness and competition; increased transparency and accountability; and reduced cost of capital for licensees.</p>

## Implementation Costs

There are some additional costs on Government and Ofgem associated with implementation of the Third Package that are not captured elsewhere. These costs are associated with drafting and implementing licence changes. We estimate the costs on Government to be a one-off transitional cost of approximately half a million pounds. Ofgem advise that the one-off cost to them of drafting licence changes is in the region of £150k.



## Post Implementation Review

Table 8 below sets out DECC's Post Implementation Review plan for GB implementation of the EU Third Package.

**Table 8: Post Implementation Review Plan**

**Basis of the review:**

DECC will review its approach to implementation of the Third Package within 5 years, to ensure it still meets the stated policy objectives, and to inform the European Commission's own considerations of the success of the legislative package.

**Review approach and rationale:**

DECC and Ofgem will continue working closely with stakeholders during the implementation phase. Wherever appropriate, DECC may request data from the energy suppliers as further evidence of how the implementation phase is working.

**Baseline:**

The implementation of the Third package formalises or introduces new requirements; the baseline is the position before these policies were introduced or formalised.

**Success criteria:**

Implementation will be reviewed against the original success criteria, including whether the policy is working on the ground, the costs to business and the benefits to consumers.

**Monitoring information arrangements:**

The Third Package sets out certain monitoring and enforcement responsibilities for Ofgem. For certain aspects of implementation, Ofgem will provide guidance and update its enforcement guidelines. DECC will continue to work with the regulator to assess the impact of the Third Package measures and to ensure that the framework works efficiently.