nationalgrid

National Grid House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

Third Package Consultation Team
Department of Energy and Climate Change
Area 4 C
3 Whitehall Place
LONDON
SW1A 2HD

[redacted]
[redacted]@uk.ngrid.com
Direct tel +44 (0)[redacted]

www.nationalgrid.com

29 October 2010

Dear Sir / Madam

CONSULTATION ON LICENCE MODIFICATION APPEALS

National Grid welcomes the opportunity to respond to the Department of Energy and Climate Change "Consultation on licence modification appeals" (the Consultation) associated with the Implementation of the EU Third Internal Energy Package.

National Grid, through National Grid Electricity Transmission plc ("NGET") owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator (NETSO), operates the National Electricity Transmission System in Great Britain, which includes both of the Scottish transmission networks and which will, in due course, include offshore transmission systems. National Grid also, through National Grid Gas plc ("NGG"), owns and operates the gas transmission system in Great Britain and four of eight gas distribution systems in Great Britain.

This response is made on behalf of the whole of the National Grid group of companies. It is not confidential. The response should be read in conjunction with our response to the DECC Consultation on Implementation of the Third Internal Energy Package (sent on 19 October 2010 to the Third Package Consultation Team at DECC).

DECC Consultation on licence modification appeals.

We are very concerned at the proposal set out in the Consultation to remove the existing collective licence modification procedure and replace it with a system which allows Ofgem to impose a licence modification, subject only to a limited right of appeal. We feel that this proposal is unnecessarily broad in scope and will undermine the principles of good industry governance that have developed in the gas and electricity industries since privatisation.

We are surprised that such "gold-plating" of the EU's requirements has been proposed without any detailed assessment having been carried out as to whether this approach is justified. We do not consider that the proposals can be justified on the basis of the very limited consultation on what is a fundamental change to the "regulatory settlement" set out in the Gas and Electricity Acts.

Consideration of the manner in which licences are modified lies at the very heart of the electricity and gas regimes in the United Kingdom, yet it a fundamental shift in the relationship between regulator and regulated companies is being proposed on the basis of just five paragraphs set out in a consultation covering the whole range of issues arising from the implementation of the Third Package, followed up by what is a very "thin" consultation in October 2010 giving interested parties less than a month to

respond. Certainly, this does not adequately satisfy the requirements for the duration of consultation exercises set out in the Government's own Code of Practice on Consultation.

Furthermore, this approach does not appear to be in accordance with the requirements set out in the Cabinet Office Transposition Guidance on the implementation of EU law which clearly state that the "gold plating" of the requirements of EU law is only justifiable where there are exceptional circumstances, backed up by strong cost-benefit analysis and extensive consultation with business. The only cost-benefit analysis provided seeks to introduce these proposals is in the Impact Assessment. This contains very little extra material in addition to the consultation and, importantly, does not quantify the costs and benefits of DECC's preferred solution against either a 'Business As Usual' approach (i.e. assuming the current process remains in place) or even against the minimum implementation solution mentioned in the Consultation. Indeed, this assessment appears to consist largely of the same material as is set out in the Consultation itself, together with some unsubstantiated assertions about the implications of the proposed change. Therefore, it does not appear to satisfy either the requirement for strong analysis or for extensive consultation.

In this context, and in the absence of the ability of Licensees to block proposed licence changes we would have to rely on the regulator's adherence to better regulation principles in its decision making. However, we note that regulators frequently come under time pressure leading to situations where these principles are not followed – for example the recent consultation process followed by Ofgem on the offshore transmission regime:

- *Consultation letter on version 0.6 of the draft generic Offshore Transmission Owner Licence – issued on 3 Sept 2010 requiring comment by 17 Sept 2010*
- *Offshore Electricity Transmission: Further consultation on the Enduring Regulatory Regime issued 26 August; material comments to be submitted by 9 September.*

Such short timescales (in the second case 2 weeks in the holiday season spanning a bank holiday weekend when it is inevitable that potential respondent's resources are likely to be particularly limited) give us little confidence that the better regulation principles will always be adhered to. We therefore have grave concerns that the new licence change regime proposed would provide the opportunity for Ofgem to introduce licence changes that had not be adequately considered and consulted on, even if they had been subject to a 28 day statutory consultation.

We consider that the issue of whether the current proposal constitutes unnecessary "gold plating" of the requirements of the Directive must be determined only after answering the following questions about the proposed change to the licence modification process:

1. *Is this necessary?*
2. *Is this desirable?*

Once these questions have been answered, this note goes on to consider the following issues:

3. *What changes are necessary to implement the Third Package?*
4. *Can the Government's proposals be implemented other than by primary legislation?*

Without answering these questions satisfactorily, we consider that the proposed changes run the risk of challenge in the courts.

Taking each of these in turn in relation to the proposals:

1. Is this necessary?

As we indicated in our response to the July consultation, we do not believe that compliance with the Directives inevitably leads to the Government being required to make the general change proposed to the licence modification rules. The requirements of the Directive only apply to the functions set out in the Directives. While these do include a duty to implement decisions of ACER and the Commission, they do not include all of the matters that could potentially be within the scope of licence conditions. This means that, on any analysis, the proposals go beyond what is necessary to implement the Third Package and are, therefore "gold plated". Indeed, the Consultation recognises that the proposal "does exceed the minimum requirements of the Directive" – paragraph 1.7. As such they should be subject

to much more rigorous policy development and consultation than appears to have been applied in the present case in order to meet the Cabinet Office Guidance.

Furthermore, the Consultation paper presents no evidence that the existing arrangements do not allow Ofgem to carry out the duties required by the Directive (or indeed to make any licence change) in an "efficient and expeditious manner". This requirement in the directives is vague and capable of interpretation within the discretion open to Member States. We consider that the present arrangements, by allowing consensus to be built, already meet this requirement by avoiding lengthy disputes and appeals.

While the Directive requires a suitable mechanism to be available to allow a party affected by a decision of a regulatory authority to appeal to an independent body, it is not clear that this obliges Member States to make anything other than judicial review to be available. Judicial review is available at present to every licensee and interested third party, and this seems to be sufficient, especially since the preceding provisions of the Directives refer to the giving of reasons to 'allow for judicial review'. It certainly does not enable the conclusion to be reached that the availability of judicial review is inadequate to meet this obligation.

In any event, the procedures for the current collective licence modification merely set a consensual bar which entitles Ofgem to impose a modification, but does not require any modification to be made: the decision whether to make the modification is made only after the objections have (or rather have not) been received following a final statutory consultation round. Judicial review is still available to all parties with the necessary standing after this decision is made. Through the requirement to demonstrate this standing in order to launch a judicial review, sufficient protection (i.e. a right of appeal) for every "party affected by a decision of a regulatory authority" is available.

We note that the Consultation of 1 October seeks to introduce further arguments that the present licence modification rules do not allow the regulator be able to make "autonomous decisions". The emphasis on this requirement seems very strange, since this has been a requirement of the EU rules for some time, for example, being enshrined in Article 23 of Directive 2003/54/EC. Indeed, if the present arrangements did not satisfy this requirement, we would have expected that the European Commission would have drawn attention to this deficiency in its infraction proceedings in relation to implementation of the Second Package. However, it did not, so we can assume that the Commission does not have any issues with the present protections for the independence of Ofgem and therefore no action is required. Secondly, references in the Directives to "autonomous decisions" are restricted to the section related to requirements for independence of the regulatory authority from any political body and for autonomy in the implementation of the allocated budget (Article 35, paragraph 5(a) of the Electricity Directive) as opposed to the 'general autonomy' which is assumed in this Consultation. In the previous consultation on the implementation of the EU Third Internal Energy Market Package, DECC stressed their view that, in respect of the specific requirements above, current arrangements are "already compliant with the requirements of the Directives" (paragraph 4.20).

In this context, the current Consultation misrepresents the way in which the present licence modification procedure works to suggest that that it operates to prevent Ofgem from acting in a manner that is independent from any political body. The procedures have no such effect: Ofgem is, under the present rules, clearly in a position where its decisions are made wholly without the intervention or interference of third parties, and this is fundamental to the scheme of regulation established by the Utilities Act 2000. The only fetters on Ofgem's independence are the very limited ability of the Secretary of State to issue guidance to the Authority on social and environmental matters set out in, for example, section 4AB of the Gas Act and the requirement to consult the HSE set out in section 4A of that Act. In all other respects, the Authority is required to make its decisions independently and in accordance with its general duties under the Gas and Electricity Acts. This approach in itself is sufficient to ensure that the decision making of the Authority is independent of all other interests. Indeed, if the Authority were to make its decisions in any other manner, it would be challengeable by way of judicial review for acting outwith its duties.

Recital paragraphs 33 and 37 of the gas and electricity directives respectively state that the independent body to which a party affected by the decision of a national regulator has a right to appeal 'could be a court or other tribunal empowered to conduct a judicial review'. Although the Consultation asserts that a mechanism over and above an ability to bring a claim for judicial review is required, the

grounds of appeal that are actually proposed in the Consultation document are themselves virtually indistinguishable from the standard grounds for the judicial review process.

Given the flexibility of judicial review, and the ability of the common law rules to adapt to give the courts an appropriate level of scrutiny over regulators' decision, our view is that a convincing case for a reform which will radically alter the balance of power in the industry has not been made and as such no change is required.

2. Is this desirable?

We consider that the present approach, which ensures a broad measure of consensus is arrived at, reflects the notion that a licence is, in essence, the property of its holder. As such, changing its conditions interferes with that property and therefore the regulator's powers need to be constrained. The use of a veto or blocking minority is a valuable right which this proposal will remove because Ofgem would be able to make any licence modification of its choosing, subject only to prior consultation. The proposal therefore reverses the current position since a licensee would be required to appeal in order to overturn a decision that had already been made by a regulator. We are concerned that this change will inevitably lead to a shift in "power" between the energy industry and its regulator as Ofgem will gain significantly more ability to direct and control the industry than it presently does. This will inevitably weaken the current discipline on Ofgem actively to engage with the industry in order to reduce the risk of references to the Competition Commission. This discipline promotes good regulatory practice and avoids legal disputes from developing, as Ofgem is encouraged to modify proposals to address industry concerns, even if the licence modifications which ultimately arise are not welcomed by the industry. As such, the proposed revised licence modification arrangements can only lead to more disputes and appeals than have been observed up to now, with an inevitable impact on the industry in terms of costs, uncertainty and delay to the detriment of consumers.

We would also note that much of the benefit of the consultation process lies in the ability of licensees to improve the clarity of the proposals brought forward by Ofgem, often involving very detailed drafting comments. The effectiveness of this process can be seen from both:

- the very small number of examples of cases in which licensees have either refused individual modifications or used a blocking minority (4 out of 97 modifications over a period of 7 years – page 12 of the Impact Assessment); and
- the high quality of the drafting, clarity, and user friendliness of electricity and gas licences, especially when compared to equivalent licences in other sectors (such as water).

An ability for Ofgem to impose licence changes bypassing parts of the consultation process and therefore losing the improvements that can be garnered from the iterative nature of many consultation processes will not only reduce the quality of policy formation, but also the quality of the drafting by which such proposals and policies are implemented. This is likely to reduce the ability of licensees to know with certainty the exact nature of the obligations imposed on them, thereby increasing uncertainty, and therefore risks and costs for licensees, as the obligations to which they are subject will likely, over time, become less clear and consistent. Investors in regulated infrastructure companies such as National Grid value the stability and certainty that the current regulatory framework provides given that the investments we make are long lived. The proposals being consulted on create the risk that over time small changes to the licences implemented by Ofgem could erode a Licensees' rights or, or impose additional obligations on them. Each change may of itself be small - making it difficult to mount a successful challenge against any individual change, but over time the cumulative effect could become significant. The fundamental shift in relationship between the regulator and regulated companies could therefore result in investors perceiving that the level of regulatory risk has increased leading to an increase in the cost of capital. While any such change might be marginal, when applied to the regulated asset bases of all the regulated network companies in Great Britain the cost to consumers could be material. This issue has not been addressed in the impact assessment.

The proposed approach of introducing an "implementation and appeal" process is also likely to increase costs for consumers because an appeals process is likely to be more formal and legalistic than an effective consultation process and tie up more resources at both the licensee companies and

Ofgem. Experience of the Code Modification appeals process indicates that, despite the compressed timescale for hearing such appeals, the process is expensive and burdensome for parties involved, not least because it leads to extensive use of external counsel by companies which would not be necessary were an effective consultation process (such as that presently guaranteed by the collective veto and consent requirements) to continue.

On the basis of the above, we do not consider that the proposals meet the requirements for gold plating of EU requirements and, especially given that they have not been the subject of satisfactory consultation, we do not consider that they should be implemented.

3. What changes are necessary to implement the Third Package?

We acknowledge that it might be argued that the implementation of the Third Package in Great Britain may require some changes to be made to the existing rules to ensure that Ofgem has all of the powers it needs, particularly to implement the decisions of ACER. However, this does not either require or justify re-writing the licence modification process for the reasons set out above. Even if it did, any such changes should only extend to the scope of the Third Package (i.e. limited to implementing the decisions of ACER) rather than the full range of matters covered by licence conditions (which is far wider). If this approach were to be adopted, licensees would retain the right to keep Ofgem within its power to impose changes beyond those necessary to implement the decisions of ACER, as such wider changes would exceed Ofgem's powers and be susceptible to judicial review. That said, we do not consider any change is, in fact, required to meet the obligations in the Directives.

In this context, we consider that the proposal to split the process for an appeal between standard and standard special conditions on the one hand and special conditions relating to price controls on the other (in order to retain the right of the Competition Commission to review price control-related conditions) misunderstands the means by which price controls are implemented. Price controls are implemented by means of a suite of licence modifications, some of which are indeed changes to special conditions relating to the calculation of revenues, but many of which involve changes to standard or standard special conditions, for example related to other closely associated matters such as reporting or customer service. In order to give full effect to price control determinations, it would be necessary for any conditions relating to price controls, whether standard, standard special or special, to be subject to the closer levels of scrutiny outlined in the consultation.

Finally, we consider that there is very little chance in the real world of any licensee seeking to use either an individual or collective veto in order to block a licence condition to implement an EU requirement. It would be unlikely to seek to "waste its time" seeking to oppose a change that it knew it did not have any realistic hope of resisting, even after a Competition Commission investigation, not least because it would damage its ongoing regulatory relationships.

As such, it appears that, even if a change were needed to implement the Third Package (which we do not accept) then it should be limited to a change to allow for EU requirements to be simply "passed through" to licences. Judicial review would then still be the appropriate "appeal" route for licensees to provide a check to ensure that the change as implemented met the EU requirement it was seeking to implement.

4. Can the Government's proposals be implemented other than by primary legislation?

In the light of the above, if the Government is to make any changes, it must limit the changes it makes if secondary legislation is to be used to implement those changes so that they do not go beyond what is necessary in the scope of the Third Package: changes going beyond this would exceed the powers granted by the European Communities Act 1972. The fact that the Consultation makes it clear that the proposal is a "gold plating" of the EU requirement and meets a variety of objectives (set out on page 12 of the Consultation) that are not relevant to the implementation of the Third Package makes it clear that only primary legislation is an appropriate tool for any reconsideration of the existing licence modification rules.

As a result, the government must confine itself to a more limited set of changes confined to what is necessary to implement the Third Package, or must use primary legislation to bring about a broader

change to the licence modification procedure. If this latter approach is to be adopted, the Consultation is a wholly inadequate means of seeking views on such a fundamental change to the licensing regime.

Comments on the Proposed Appeal Mechanism

Even if the proposed changes were to be implemented (which, for the reasons outlined above, we do not consider that they should be), we have the following comments on the proposed appeal mechanism.

Question 1

We consider that price controls do raise issues that are often more wide-ranging and detailed across the whole of a licensed business than are raised by many other licence changes. As such, the fundamental review conducted by the Competition Commission remains the appropriate vehicle for the appraisal of price control conditions. However, as noted above, it is not possible to divide the types of conditions between "price control" and "other" conditions crudely on the basis of whether the condition in issue is a "standard/standard special" or "special" condition. By contrast, it should also be noted that some other conditions also have very significant economic effects (for example the recent changes to suppliers' licences in relation to non-discrimination between customers) and therefore it is not clear that a compressed appellate mechanism would provide an appropriate forum for examining all the associated issues properly. As such, the code modification appeal process does not provide an appropriate model in these circumstances.

Questions 2 to 5

In the light of our response above, we also consider that, although the proposed appeal process postulates a "full re-hearing", the grounds of appeal are in fact very narrow and draw heavily on those for code modification appeals. They do not, as the present approach of a Competition Commission reference does, provide for a complete re-hearing of all the relevant issues, which ensures that the final output of the process is the "right answer" for the industry. This is particularly important given that licence conditions bring with them legally binding obligations affecting licensee's quasi-property rights and are enforced by the threat of quasi-criminal enforcement in the form of financial penalties.

It is clear that the proposals will, however, have no impact in regulator independence (which is, in any event, for the reasons outlined above, not a legitimate reason to justify any changes at this time).

Question 6

We see no justification for the introduction of a right of appeal for third parties affected by a licence modification decision. Ofgem has already considered this issue in detail in the context of its RPI-X@20 review and devised an appropriate mechanism to ensure that third parties are represented in price control proceedings more thoroughly. Also, as noted in the Consultation, access to Judicial Review is available to all affected parties.

Questions 7 and 8

We consider that the Competition Commission is probably the most appropriate body to be the appellate body. However, given the plans to merge it with the Office of Fair Trading, and given the lack of detail about how precisely those bodies will be merged, it is difficult to give a definitive answer as to whether the Competition Commission or the Competition Appeal Tribunal is the most appropriate appellate venue.

However, in order to provide an effective and expeditious appeal model, the relevant body must be put in a position where it can, where appropriate, vary Ofgem's decisions, rather than just remit them for reconsideration. This is, of course, one of the great benefits of the existing Competition Commission process.

Questions 9, 10 and 11

We consider that an appeal process which is modelled on that for code modifications provided insufficient time to allow for the consideration of the complex factual and economic matters likely to be in issue. As such, we consider that longer timescales may be appropriate, depending on the subject matter of the case. This could be achieved by giving the relevant tribunal the power to set the

timetable for the case. If this is the case, then it is clear that it should also have the ability to suspend Ofgem's decisions until the outcome of the hearing.

Questions 12 and 13

We are sceptical that it is realistic to design a mechanism for the "winner's costs to be paid by the loser", since, if Ofgem were to lose an appeal, its costs would inevitably be passed on to consumers in any event through licence fees. As discussed above, the introduction of the proposed licence modification procedure is likely to increase costs for the industry generally to the detriment of consumers without any gain in decisional quality.

Questions 14 and 15

The Impact Assessment contains only a few elements not already included in the main consultation. These are mostly concerned with the costs involved in the appeals process. Whilst the costs to each party per appeal appear to be of the correct order of magnitude, if slightly asymmetric (£175k for industry compared to £600k for Ofgem), it is clear that one of the principal factors in the total cost of the proposals (over the 20 year period) is the number of appeals per year. Our view is that this number would be significantly higher if DECC's preferred option was to be introduced than it would under the minimum implementation option (as explained in the main response). This is due in no small part to the fact that if licence modifications are clearly driven by European legislation (e.g. ACER decisions) then, under the minimum implementation option, as well as the present system, there is unlikely to be much appetite to block them. Conversely, under the DECC proposal, modifications driven by domestic issues which would have been opposed (and possibly altered to gain consent) under the current system are likely to be subject to appeal if the proposed arrangements were to be implemented.

The other principal cost (not considered in the impact assessment) is the impact of an increase in the cost of capital if investors perceive that there is greater regulatory risk following the shift in power from Licensees to the regulator and / or through the possibility for gradual erosion of Licensees' rights or imposition of additional obligations on Licensees. We therefore disagree with the assumption on page 7 that the costs of the minimum implementation option are expected to be less than the preferred package of options.

If you have any questions regarding the points made in the response please contact [redacted] in the first instance.

Yours sincerely

[by e-mail]

[redacted]