

Ofgem Review: Summary of Conclusions

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The Government remains committed to a framework of independent economic regulation for the energy sector and to Ofgem as the independent regulator. Ofgem's role is a critical part of the landscape that will enable the Government's ambitious energy and climate change objectives to be realised. With significant challenges ahead, the Government will now be taking steps to strengthen the existing framework by providing confidence that the Government's strategic policy framework and Ofgem's independent regulatory role will remain aligned and coherent.

This paper provides a summary of the conclusions of the Ofgem Review of the energy regulatory framework and the key actions that will be taken as a result. A full report will be published with the Electricity Market Reform White Paper before the summer recess.

Background

Economic regulation in the energy sector

1. The gas and electricity industries were privatised some twenty years ago and, at the same time, a system of independent economic regulation was established with protection of gas and electricity consumers' interests at its heart. To drive improvements in efficiency and quality of service, Ofgem and its predecessors have sought to use the dynamics of competitive markets wherever appropriate, and to act as a proxy for competition in the monopoly gas and electricity networks. To enable Ofgem to provide a stable regulatory environment for investors, important for securing investment in the UK as cost effectively as possible, a core feature of economic regulation has been its continued independence from Government: Ofgem is directly accountable to Parliament.
2. The Government has recently reaffirmed its commitment to independent economic regulation across infrastructure sectors, including energy, and to maintaining the strengths of the existing system: the use of competitive markets to deliver services wherever appropriate, and independence of the regulators from Government¹. For the energy sector, the independence and role of the regulator is further reinforced by the EU Third Energy Package.

¹ Government Principles for Economic Regulation. BIS. April 2011.

3. While the fundamentals of the system for economic regulation are sound, the breadth of the contribution that the energy sector is now expected to make to wider public policy goals, and the scale of the challenges ahead, has made the world of 2011 very different from that of the 1980s. For example, the energy regulator is now expected to take account of government goals to reduce greenhouse gas emissions, deliver greater renewable energy and tackle fuel poverty – adding to the complexity of its primary objective of protecting both today's consumers and those of the future. This is a complex policy landscape with a challenging set of goals to deliver over the coming decades. To provide regulatory certainty within this more complex landscape, Ofgem's independent regulatory decisions need to form a logical and coherent part of the broader strategic policy framework that is defined by Government.

The Ofgem Review

4. The Ofgem Review of the energy regulatory framework fulfils a Coalition Agreement commitment. The Review was launched in July 2010 with the publication of a call for evidence that sought views on the issues that the Review should tackle. A summary of the responses was published in December 2010: respondents were strongly supportive of the existing model of independent economic regulation, which was considered to have delivered good value for consumers and attracted significant investment to the energy sector .
5. Within this context there were, however, a number of issues raised. There was a clear and consistent message that there was a need for greater role clarity between Ofgem and Government, with a broad view that the core of the solution lay around a clearer division between Government's role in making the decisions required to set strategic policy direction and Ofgem's regulatory role. Closely related, the current legal framework, comprising Ofgem's statutory duties and Social and Environmental Guidance published by Government, was widely criticised with calls to simplify or clarify Ofgem's duties and the guidance widely regarded as lacking impact. There were some concerns that Ofgem was not effectively held to account for its decisions and that the way the regulator explained its strategy and decisions was not sufficiently robust or transparent. A range of operational issues were also raised for both DECC and Ofgem to consider.
6. These responses led the scope of the Review to be focussed around some core issues: role clarity, and the legal framework through which that is expressed; governance; accountability; and ways of working. The aims were to strengthen the regulatory environment in a way that continues to protect consumers and enables investment in the energy sector to be secured as cost effectively as possible. More specifically, the Review has sought to deliver:
 - Clarity on the strategic policy framework within which independent regulatory decisions are made.
 - Confidence that the regulator's decisions would be aligned with the Government's strategic policy framework.
 - Regulatory certainty, where clarity over the respective roles of Government and the regulator, as well as the independence of the regulator from political influence, are important components.

7. In considering options for the way forward, the Review has also taken account of a number of other complementary strands of work. Key among these are:
- DECC's review of the energy and climate change delivery landscape, which looked at Ofgem E-serve's role in administering government programmes to drive take-up of energy efficiency measures, promote low carbon energy sources, and support those in fuel poverty. The review concluded that Ofgem E-Serve should continue to deliver the programmes it currently administers for DECC and also potentially new programmes. However, both DECC and E-Serve should take forward agreed improvements in governance, programme and performance management, and reporting.
 - DECC's plans for electricity market reform, which will be set out in a White Paper before the summer recess.
 - BIS' proposals to reform the institutional landscape for competition and consumer protection as it applies across all sectors, including proposals to strengthen the application of the powers that Ofgem holds concurrently with OFT.
 - Defra's review of Ofwat, which has been carried out in parallel with the Ofgem Review and is expected to report later in the Spring.

Conclusions

8. The Government's Principles for Economic Regulation underpin the Ofgem Review's conclusions, as described in the Impact Assessment that is published alongside this paper.

Role Clarity

9. A clear division of responsibilities between Government and Ofgem should see the Government clearly responsible for setting policy direction and making the high level strategic decisions that involve political judgement. Developing regulatory policy, the detailed application of regulation and advice to Government should be carried out independently by the regulator. This division of roles is recognised in the EU Third Energy Package. However, as Ofgem's role has become more complex, there has been a blurring of responsibilities between Government and Ofgem causing some erosion of the regulatory certainty that independent regulation was designed to provide.
10. Ofgem is a body defined by statute and all of their regulatory decisions are framed by their statutory duties: Ofgem's primary objective is to protect the interests of current and future consumers, including their interests in greenhouse gas emissions and security of supply, with this remit extending across Great Britain. There is considerable room for interpretation within such broadly scoped duties and so to help ensure coherence between the Government and regulator's roles, Ofgem is also required to take account of Social and Environmental Guidance that is published periodically by Government.
11. While the guidance has been a useful tool for clarifying some issues (e.g. that it is for Government to make decisions that have significant redistributive implications, such as

provision of financial support for the fuel poor; that Ofgem should ensure consumers, including those paying by a prepayment meter, do not suffer undue economic disadvantage as a result of their payment method), its effectiveness has been limited by: its weak legal status in comparison to Ofgem's other duties, together with weak arrangements for accountability; that Government has sometimes allowed the guidance to become out of date; and the scope does not cover some important issues such as security of supply.

12. The Review has concluded that Ofgem's statutory duties appropriately reflect the issues that the regulator should consider in making their decisions. However, the current framework of broadly scoped duties and weak guidance is very unlikely to be able to support a predictable regulatory environment as the energy sector goes through a period of substantial change over the coming decades driven by wider public policy objectives, such as those related to climate change and security of energy supply.

Governance

13. Good corporate governance is fundamental to any effective organisation. The Gas and Electricity Markets Authority (GEMA) is the legal entity that has the powers to regulate the gas and electricity markets; it is also the board that provides corporate governance for Ofgem, as its executive arm. The members of GEMA are appointed by Government and Government is therefore, in effect, GEMA's primary shareholder. However, Government has no involvement either in GEMA's regulatory or operational decisions, including the operation of corporate governance systems.
14. The composition of GEMA reflects that commonly adopted for boards in the UK, including by the other economic regulators: a mix of executive and non-executive members, with a majority of non-executives and a non-executive chair (the unitary model). Economic regulators in other countries tend to adopt a structure where the board comprises non-executive members only (the two tier model).
15. We consider that the unitary model brings benefits in that there is value in having executive knowledge within the board, alongside non-executive directors who can bring wider experience. The unitary model is also particularly appropriate where it is the shareholder(s) that establish the goals of an organisation, with a unified board capable of making and implementing decisions more efficiently than under a two tier structure. Currently, these goals are established through GEMA's statutory duties and the Social and Environmental Guidance, whose shortcomings have already been discussed.
- 16. The Review has concluded that the Government should play a stronger role in setting the strategic direction of the organisation and ensuring that GEMA is held to account for their achievements against strategic goals.**

Accountability

- 17. Accountability plays an important role in establishing the legitimacy of decision makers and depends on transparency, a requirement to explain decision making, exposure to scrutiny and the right to challenge decisions.**

18. Ofgem itself aims to operate transparently by, for example, publishing a corporate strategy, an annual report, and the minutes of GEMA meetings; consulting extensively and publishing their decisions; and holding regular stakeholder events and seminars. Despite this broad range of activity, the experience of some stakeholders is that Ofgem is not transparent in the way that it conducts its business. While in part an internal operational matter for Ofgem to consider, processes such as the corporate strategy and annual report have a legislative basis.
19. It is Parliament that grants Ofgem its mandate and for the most part it is for Parliament, supported by the NAO, to scrutinise Ofgem's activity. This includes scrutiny of whether Ofgem is providing value for money and it is Parliament, rather than Government, that approves Ofgem's budget.
20. DECC, as the Government department that has responsibility for providing Ofgem with strategic direction, ensuring that Ofgem is operating with the appropriate legislative underpinning, and appointing board members, has a responsibility to ensure that the framework for accountability remains fit for purpose, as this Review has sought to do.
21. An important safeguard is the ability of those affected by Ofgem's actions to be able to challenge their decisions. Regulated companies and Consumer Focus, acting on behalf of consumers, can appeal to the Competition Commission on certain types of decision, while any interested party can take Ofgem to judicial review.
- 22. The Review has concluded that the current framework for accountability would be more effective if Ofgem's strategy, decision-making and operations were seen to be more transparent.**

Key Actions

- 23. The Government commits to communicate more clearly its policy goals for the gas and electricity markets and the respective roles and responsibilities of Government and Ofgem in defining and delivering those goals.**
- 24. The Government will define policy outcomes that Ofgem has an important role in delivering, or helping to deliver, and will seek legislative provision to require Ofgem to justify its independent regulatory decisions against these outcomes.**
- 25. Purpose.** This is a strengthening of the existing regulatory framework and is intended to increase regulatory certainty by requiring Government to be clearer about its strategic policy framework, ensuring that there will be coherence between this framework and the regulator's actions, and providing a transparent and enduring process through which the Government and Ofgem can consider progress and barriers to meeting strategic policy goals.
- 26. Implementation.** A new statutory 'Strategy and policy statement' will be established. This document will set out the Government's policy goals for the gas and electricity markets and describe the roles and responsibilities of Government, Ofgem, and other relevant bodies. It will also define policy outcomes that Government considers Ofgem to have a particularly

important role in delivering. These outcomes will, in future, provide the context for Ofgem's regulatory decisions under its existing duties. Ofgem will continue to operate independently in deciding how to regulate the energy markets, but they will be required to demonstrate how their decisions support the successful delivery of the policy outcomes defined by Government in the Strategy and policy statement.

27. **Process.** The Strategy and policy statement will be prepared by Government, who will ensure that it is compatible with the requirements of the EU Third Energy Package and future EU legislation. To ensure that the Government fully understands the potential impacts on the energy market of its framing of the Strategy and policy statement, Government will consult with Ofgem and, we anticipate, more widely. Approval from Parliament will be sought before the Statement takes effect.
28. **Accountability.** Ofgem will be expected to set out annually how it plans to deliver its contribution to the policy outcomes and how it will monitor progress. In some cases, delivery of a policy outcome will be solely under Ofgem's jurisdiction. In others, Ofgem will have an important role but hold only some of the levers and will not, on its own, be expected to ensure successful delivery but rather to articulate clearly its own role. Ofgem will be expected to report annually on progress, outlining and justifying decisions and, where progress is not on track, explaining why this was the case and whether any mitigating action was needed.
29. **Governance.** The Strategy and policy statement will provide strategic direction to GEMA and provide a new focus for Government and GEMA to consider the challenges ahead for the energy sector.
30. **Adaptability.** The Strategy and policy statement will be intended to remain stable over at least the length of a Parliament. To balance this desire for stability with the need to maintain coherence with the broader policy framework, it will be possible for Government to seek a change in the Strategy and policy statement should there be a significant change in policy. Legislation would require that any change be preceded by consultation at least with Ofgem, and potentially others, and approval by Parliament, both of which are intended to act as a constraint on Government and prevent unnecessary change.
31. **Consequential amendments to duties and guidance.** We do not anticipate making changes to the existing framework except as required to ensure effective incorporation of the Strategy and policy statement. The factors that Ofgem must consider in making their regulatory decisions, as described by their current statutory duties, will remain unchanged. It is right that Ofgem should continue to consider trade-offs between economic and broader goals albeit within the context set by the Strategy and policy statement. The Social and Environmental Guidance will, however, be superseded by the Strategy and policy statement and repealed.
32. **Timing.** The Strategy and Policy Statement will be established under new primary legislation, which will be introduced as soon as Parliamentary time allows.

Next Steps

33. A full report of the Ofgem Review, which will set out in more detail the background to the Review and the evidence considered, will be published with the Electricity Market Reform White Paper before the summer recess.
34. In the meantime, any questions or comments should be directed to:
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