

Title: Government Strategy and Policy Statement for the gas and electricity markets Lead department or agency: DECC Other departments or agencies:	Impact Assessment (IA)
	IA No: DECC0060
	Date: 19/05/11
	Stage: Final
	Source of intervention: Domestic
	Type of measure: Primary legislation
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Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

The context in which the Gas and Electricity Markets Authority (GEMA), and its executive arm Ofgem, works has changed significantly since economic regulation was established in the 1980s. The role of the regulator is now much more complex than originally envisaged, with an important contribution to make to Government's wider policy goals for the energy sector such as climate change objectives. One consequence is that a lack of clarity over the respective roles of GEMA and Government has developed, which is causing regulatory uncertainty. There is a need to clarify these roles and provide confidence that there will be coherence between Government policy and regulation.

What are the policy objectives and the intended effects?

The overarching aim is to increase regulatory certainty and so enable investment in the UK energy sector to be secured as cost effectively as possible. The specific objectives are to ensure coherence between the Government's strategic policy framework and the actions of the independent regulator. This is also intended to provide a transparent and enduring process through which the Government can specify the policy outcomes it expects the regulator to contribute to and against which the regulator can be held to account.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

All options include the assumptions that GEMA's existing duties will not change except for, under options 2 and 3, the duty relating to the Social and Environmental Guidance ('Guidance') and/or a new duty around the legally binding 'Power to Direct' or 'Strategy and Policy Statement'.

Option 1: Do nothing. This would mean looking at non-legislative options for making the current approach, including providing Guidance to GEMA on wider policy goals, more effective.

Option 2: establish a new ad hoc 'Power to Direct'. This would mean taking a power for the government to define individual policy outcomes that GEMA would be legally bound to operate in line with whenever the Government saw fit and within the independence constraints imposed by the EU Third Package. The existing Guidance could be repealed.

Option 3: establish a new 'Strategy and Policy Statement'. This would mean Government periodically establishing a coherent set of policy outcomes that GEMA would be legally bound to justify their actions against, expected to remain stable over a Parliament. The existing Guidance would be repealed. This is the preferred option because it offers the most coherent, stable and predictable approach.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** See Annex 1

What is the basis for this review? PIR **If applicable, set sunset clause date:** N/A

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?

Yes

Ministerial Sign-off For final stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: 

Date: 18 May 2011

Price Base Year 2009	PV Base Year 2010	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: N/A	High: N/A	Best Estimate: 0

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	N/A	N/A	N/A
High	N/A	N/A	N/A
Best Estimate	0	0	0

Description and scale of key monetised costs by 'main affected groups'
 There are not anticipated to be any increase in monetised costs for any groups as a result of this proposal. We have considered the potential for there to be an increase in legal costs. This could come about if a clarification of GEMA's objectives increased the number of legal challenges. However, on balance we do not consider that there will be any net increase in the number of legal challenges and therefore no additional monetised costs.

Other key non-monetised costs by 'main affected groups'
 There are not anticipated to be any increase in non-monetised costs for any groups as a result of this proposal. There are no new functional duties being placed on GEMA. This 'Strategy and Policy Statement' should only clarify to GEMA and other market participants the role of GEMA and the strategic policy framework within which it will make its regulatory decisions.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	N/A	N/A	N/A
High	N/A	N/A	N/A
Best Estimate	0	0	0

Description and scale of key monetised benefits by 'main affected groups'
 There are not expected to be any monetised benefits accruing to any groups as a result of this clarification of GEMA's role and objectives.

Other key non-monetised benefits by 'main affected groups'
 The proposal is expected to increase regulatory certainty by providing greater role clarity between Government and GEMA and establishing transparent processes by which this is achieved, while protecting the independence of the regulator in making regulatory decisions. This reduction in regulatory uncertainty can help to secure investment in the energy sector as cost effectively as possible.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
We assume that the exact wording of the Strategy and Policy Statement will produce a coherent set of legally binding outcomes that do not have unintended consequences and that are deliverable. We assume that GEMA will work towards the outcomes defined in the Strategy and Policy Statement to avoid legal action. There is a risk that the Strategy and Policy Statement may be revised too often taking away the stability advantages it has over an ad hoc power to direct.		

Direct impact on business (Equivalent Annual) (£m):	In scope of OIOO	Measure Qualifies as
Costs: 0 Benefits: 0 Net: 0	Yes	IN

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?	Great Britain				
From what date will the policy be implemented?	TBC – Will need primary leg				
Which organisation(s) will enforce the policy?	Government (DECC)				
What is the annual change in enforcement cost (£m)?	£0m				
Does enforcement comply with Hampton principles?	Yes				
Does implementation go beyond minimum EU requirements?	N/A				
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)	Traded: N/A		Non-traded: N/A		
Does the proposal have an impact on competition?	No				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?	Costs: 0		Benefits: 0		
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	Micro N/A	< 20 N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
Statutory equality duties¹ Statutory Equality Duties Impact Test guidance	No	N/A
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	N/A
Small firms Small Firms Impact Test guidance	No	N/A
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	N/A
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	N/A
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	N/A
Human rights Human Rights Impact Test guidance	No	N/A
Justice system Justice Impact Test guidance	No	N/A
Rural proofing Rural Proofing Impact Test guidance	No	N/A
Sustainable development Sustainable Development Impact Test guidance	No	N/A

¹ Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

References

No.	Legislation or publication
1	<u>Ofgem Review: Call for Evidence A Government Response</u> . DECC. December 2010
2	<u>Principles for Economic Regulation</u> . BIS. April 2011.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y ₀	Y ₁	Y ₂	Y ₃	Y ₄	Y ₅	Y ₆	Y ₇	Y ₈	Y ₉
Transition costs	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Annual recurring cost	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total annual costs	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Transition benefits	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Annual recurring benefits	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total annual benefits	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

* For non-monetised benefits please see summary pages and main evidence base section



Microsoft Office
Excel Worksheet

EVIDENCE BASE (for summary sheet)

Background

Independent economic regulation

Independent economic regulation continues to be a fundamental part of the UK Government's policy framework for the utilities sectors and has been so since the 1980s; at its heart lies the protection of consumer interests. Improvements in efficiency and quality of service are driven through the use of competitive markets wherever appropriate, and regulation acts as a proxy for competition in the monopoly gas and electricity networks.

Investment in utilities infrastructure is capital-intensive, long-term and with significant sunk costs. This is particularly true of the energy sector, which will require a step change in investment over the coming decades if we are to meet our low carbon and security of supply objectives. Given these characteristics, investors will be careful to price in the risk of political intervention, potentially affecting the cost of capital. An increased cost of capital could have a significant impact on the likelihood of an investment going ahead as well as indirectly impacting on energy bills.

In the UK the statutory framework of independent economic regulation encapsulates a commitment by the Government not to intervene other than in clearly specified ways. Appropriate economic regulation is a critical enabler of infrastructure investment and independence helps provide stability and consistency, playing an important role in preserving the confidence of investors. Government needs to have a clear structure in place to ensure that this independence of regulation is not eroded over time. At the same time, however, while there are significant benefits to economic regulation being conducted separately from Government, it does need to form a coherent part of wider public policy. If it does not then its predictability will be undermined by a lack of alignment with Government's overarching goals and lead to a lack of clarity and confusion for consumers and investors alike. Predictability will become undermined if Government and the regulator give conflicting signals to companies. Further to this, if Governments objectives become at risk due to actions of the regulator it is likely that Government will then intervene later using primary legislation within the confines of the EU Third Internal Energy Market Package ('EU Third Package'). Regular intervention by the Government in the duties of the Regulator reduces predictability and makes investment returns more uncertain and therefore less attractive.

To avoid this, the regulatory framework does need to be kept up to date, although not in a way that is ad hoc and impossible to anticipate. A balance needs to be struck with Government being clear up front about the process that it will use to maintain this coherence with the regulator.

The Government's Principles for Economic Regulation and Commitments

The government has recently reaffirmed its commitment to independent regulation through the Government's Principles for Economic Regulation² (the 'Principles'). These set out the characteristics of a successful framework for economic regulation: accountability, focus, predictability, coherence, adaptability and efficiency (the definitions are set out in [Annex 2](#)). The Principles underpin the assessment of the options being proposed in this Impact Assessment and are considered as part of the cost benefit analysis. Alongside the Principles, the Government has also made the following associated Commitments (summarised below) of which 1 to 5 are particularly relevant. Commitment 8 is being addressed through the execution of this assessment:

- 1. The Government commits to ensure that responsibilities are clearly divided between Government and the regulator on the basis that high level decisions that involve political judgement are taken by Government and day-to-day regulatory decisions are undertaken by the regulator.
- 2. The Government will preserve the independence of economic regulators.
- 3. The Government commits to put in place for every regulated sector strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes.
- 4. The Government will expect regulators to follow consultation best practice in their decision making.

² Principles for Economic Regulation. BIS. April 2011.

- 5. The Government will ensure that regulators' objectives are clear and appropriately prioritised (including through broader guidance) to reflect the issues that the regulators should take into account in their decisions.
- 6. The Government will review the impact of Part IV of the Regulatory Enforcement and Sanctions (RES) Act 2008 on economic regulators and will expect regulators to adopt best practice to improving regulator's efficiency.
- 7. The Government will encourage the Joint Regulators' Group to adopt a more systematic approach to issues of cross-sector coherence and best practice.
- 8. The Government will assess any proposed changes to the regulatory frameworks against the Principles for Economic Regulation and demonstrate how the changes adhere to these Principles.

GEMA and the existing legal framework

The Gas and Electricity Markets Authority (GEMA) is the independent economic regulator for the gas and electricity markets in Great Britain and is directly accountable to Parliament. GEMA's functions include the licensing of gas and electricity activities, enforcing those licences, monitoring competition in the market, and running network price controls. GEMA and its executive arm Ofgem were created through the Utilities Act 2000 by merging the previous gas and electricity regulators, Ofgas and OFFER.

The Utilities Act 2000 specified that GEMA's principle objective was to protect the interests of current and future electricity and gas consumers. Subsequently, GEMA's statutory duties have been subject to several changes intended to clarify the regulator's role and align it to the Government's priorities. The most recent change was in the Energy Act 2010, which clarified that current and future consumers' interests included their interests in reducing greenhouse gas emissions and maintaining security of supply.

The Utilities Act 2000 also introduced Social and Environmental Guidance (the 'Guidance') that would be issued by Government and to which the independent regulator would need to *have regard to*. The rationale for publishing Guidance that described Government's social and environmental policy priorities included a concern that the incumbent regulatory framework did not fully reflect the importance of the regulated energy companies to the achievement of these wider policy objectives.

The original Guidance was issued in 2002 and was subject to revision in 2004 and 2010. The revisions reflected revisions to overarching Government policy and were intended to help provide consistency between the Government's strategy and the regulator's decisions.

Problem under consideration

In July 2010 the DECC Secretary of State announced a review of the role of GEMA in regulating the energy markets (the 'Ofgem Review'). A call for evidence was launched to help inform the scope of the review and views were requested on issues such as the future objectives for independent regulation of the energy sector, the boundary of responsibility between the Government and the regulator, whether GEMA's existing duties were fit for purpose, the effectiveness of the Guidance and the value for money that the regulator provided. In particular, the remit of the Ofgem Review included assessing whether any changes were needed to provide greater alignment of the regulatory framework with Government's strategic policy goals (see Commitment 1 in the section above).

The Government's summary of responses to the Call for Evidence was published in December 2010³ and confirmed that:

- Government remained committed to ensuring that Great Britain has an effective energy regulatory framework;
- This regulatory framework would continue to be overseen by an independent regulator.

This position was supported in the responses to the Call for Evidence, with the existing framework and regulatory independence being highly valued. However, within this, the majority of stakeholder responses identified two main areas where it was considered that the existing arrangements could be improved in order to reduce uncertainty in the market and, therefore, support cost-effective investment in the gas and electricity sectors:

³ Ofgem Review: Call for Evidence A Government Response. DECC. December 2010

- **Role clarity:** Since the regulatory framework for gas and electricity was established in the 1980s the political context within which the energy sector has operated has changed significantly. The sector is now expected to contribute to wider political goals including the reduction in greenhouse gas emissions, increased renewable generation and mitigation of the impacts of fuel poverty. Increasingly over the last decade the energy market framework, and the regulation that underpins it, has been driven by environmental and social policy as well as economic efficiency goals. Given the significant policy challenges and the substantial change implied for the energy sector, this will continue to be the case. The previous changes to GEMA's duties and the Guidance had tried to define the regulator's role within the changing landscape, but it was clear from the Call for Evidence responses that this had not had the desired result.

There was a clear and consistent message that there was a need for greater role clarity between GEMA 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 GEMA's independent regulatory role. The Government has committed, through the Principles, to ensure that responsibilities between Government and the regulator are articulated as clearly as possible in order to allow the regulated sectors to know who is responsible for what and to whom they are accountable (see also the definitions of *accountability* and *focus* in Annex 2). This will be particularly important for the energy sector, given the scale and pace of change anticipated over the coming decades.

As described above, the existing legislative framework for GEMA comprises its existing principle objective and statutory duties and the Guidance. Although Government considers that the existing duties do reflect the right general policy balance (requiring the regulator to consider economic, social and environmental goals when making its regulatory decisions) they have not been able to provide the strategic direction required. They leave considerable room for interpretation, and give the regulator responsibility for making trade-offs between policy goals such as security of supply and environmental sustainability that can have significant implications for delivery of Government policy and are arguably for Government to make. As described in Government's Principles paper, setting policy direction and making politically sensitive trade-offs between objectives is likely to require democratic legitimacy and accountability, and is clearly the role of Government. It also states "Government should not avoid making these difficult policy decisions or pass them to regulators to determine."

While the Guidance has been a useful tool for clarifying some issues, it is generally judged to have had little impact. This can be explained by: its weak legal status in comparison to GEMA's other existing duties; 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. As described in the Call for Evidence summary, the result has been a blurring of responsibilities and some erosion of the regulatory certainty that independent regulation was designed to provide. For example, as the current regulatory regime does not allow for Government to specify how the regulator's decisions should co-ordinate directly with Government's goals, this can lead to potential disagreement. For example, the Call for Evidence responses suggested that the Government's carbon targets might be at risk from a lack of enabling action by the regulator. In extreme cases, and within the constraints of the EU Third Package, the Government could choose to use primary legislation to intervene on an ad hoc basis. Such intervention scenarios will tend to increase the political risk associated with investment decisions and should be avoided wherever possible.

A future example where we would want to ensure that objectives are aligned would be the roll out of smart grids. The development of distribution networks over the next two decades will be a key enabler of the low carbon transition. In particular networks will need to play a proactive role in a more integrated future energy system so they do not act as a barrier to the development of new distributed energy resources, such as Demand Side Response (DSR) and Distributed Generation (DG) that can help to balance the future electricity system. The regulator will play an important role in incentivising networks to make these changes as appropriate. However, there is currently no formal way to transparently align the regulators objectives with broader government policy goals.

- **Accountability of the regulator:** Related to role clarity, responses to the Call for Evidence raised concerns that GEMA is not effectively held to account for its decisions and that the way GEMA itself explains strategy and decisions are not sufficiently robust or transparent. A clear framework for accountability is one of the Government's Principles for Economic Regulation (see Annex 2).

Rationale for intervention

As described above, the role of the independent gas and electricity regulator has become much more complex than was originally envisaged in the 1980s when economic regulation was established. Now, further to the pursuit of effective market competition and, through this, the protection of the consumer, the energy sector must also play its part in meeting our climate change objectives, maintaining security of supply and supporting vulnerable consumers.

Previous amendments to GEMA's principal objective and statutory duties and the Guidance have aimed to reflect these complexities within the regulatory framework but, as highlighted in the Call for Evidence responses, this has been seen to be ineffective.

The energy sector is expected to go through a period of significant change over the coming decades, driven by public policy rather than economic efficiency goals and with substantial levels of new investment needed. While the underlying framework of independent economic regulation is sound, there is a question over whether the current structure of duties and guidance will be able to support a predictable regulatory environment for investors; important for securing investment in the UK as cost effectively as possible.

The priority is to maintain regulatory independence, while ensuring that respective roles of Government in setting strategic direction and GEMA in taking regulatory decisions are clear.

Policy objectives

The driving objective is to allow investments to be made in the energy sector as cost effectively as possible. To achieve this objective, regulatory uncertainty must be minimised. This policy aims to address uncertainty stemming from lack of role clarity between Government and the independent regulator, a lack of coherence between the regulatory framework and government policy or overly frequent changes to the regulatory regime. Following the Call for Evidence, the aims of the Ofgem Review have been to provide:

- 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.

Any potential solution must give careful consideration to the balance between the Government's six Principles for Economic Regulation. For example, any regime should maximise certainty in the market by providing a regulatory framework that is *predictable* and yet is *adaptable* enough to ensure continued *coherence* with the wider policy context. Also drawing from the Commitments that Government has published alongside the Principles (see background section above), it must ensure that the responsibilities between Government and the regulator are well defined (Commitment 1) and that there is a clear description of policy, desired outcomes and the regulator's objectives within that (Commitments 3 & 5). Importantly, in developing the Principles and Commitments, the BIS Call for Evidence received similar responses to those for the Ofgem Review. Stakeholders confirmed that, in general, Government needed to set out a clearer strategy and policy context in which independent economic regulators, consumers and investors could take informed decisions. They also noted that Government should exercise restraint when making changes to this context. The Principles were designed to help Government achieve this balance through its actions.

An overarching objective of any solution would also have to be a positive impact on reducing regulatory uncertainty in the gas and electricity markets, so improving investor confidence. Furthermore, any agreed options would need to adhere to the regulatory principles specified in the EU Third Package referred to above. In its accompanying interpretive note, the European Commission acknowledges that it is within the Government's competency to determine the policy framework, but that any energy policy guidelines produced must not encroach on the regulator's independence and autonomy (see also Commitment 2).

Any solution will need stakeholder buy-in, addressing the issues raised in the Ofgem Review Call for Evidence responses and taking account of the ongoing dialogue we have had with stakeholders (in confidence), including regulation experts and investors. This open process, which has taken the place of a formal consultation, will continue following the publication of the Ofgem Review high-level conclusions as we flesh out the process and content detail of the option chosen. Before the policy is finally established, we expect there will be a wider consultation process. A further impact assessment will be

completed before implementation, at which point costs/benefits will be assessed against the specific policy detail.

Description of options considered

Each of the three options described below do not change GEMA's current statutory duties⁴. What options 2 and 3 would do is provide overarching outcomes that must be achieved using existing statutory duties and against which GEMA must make its decisions.

GEMA is a body defined by statute and all of their decisions are made within the framework set out in law. It is crucial that its duties are coherent with the factors that Government wants the regulator to consider in making its decisions, but we should also aim for the duties to remain stable over as long a period as possible in order to provide predictability for the market. This stability has not been realised over the last decade with changes being made in the 2004, 2008 and 2010 Energy Acts.

When considering the future of the existing duties, it is necessary to decide how far we want the regulator's statutory duties to embed wider public interest goals (such as those related social, environmental, security and safety issues) alongside its core economic goals. The existing duties provide a balance of such interests, with a principal objective to protect the interests of current and future consumers, including their interests in greenhouse gas emissions and security of supply. There are two main reasons for retaining the existing duties as they are. First, analysis has suggested that the duties already reflect the right general policy balance, requiring the regulator to consider trade-offs between economic, social and environmental goals when making its regulatory decisions. Second, an active decision to not change the detail of the existing duties will send a positive stability message to stakeholders. Instead, we need to find a way to ensure that GEMA's decisions are taken in line with the broader strategy and policy context.

Given this conclusion on the existing duties, the Ofgem Review has considered three main options for addressing the role clarity and accountability issues discussed above.

1. Do nothing

As for each option, the independence of economic regulation, and the stability and predictability benefits that this brings (see background section above), will remain at the heart of the Government's approach. In this 'do nothing' scenario the legislative framework would remain with GEMA's existing principal objective, statutory duties, the Guidance that the regulator must have regard to and the potential for Government, in extremis, to make specific changes to regulatory detail through primary legislation.

Although, as described above, we are not choosing to change the existing duties on this occasion, this would still be a possibility for Government during each subsequent Energy Bill. This option has been taken up frequently over the last decade because it is the principle tool with any legal strength for aligning the regulator with Government's priorities. It is possible that in the future the Government would consider that Ofgem's functional duties are not leading it to act in a way that is coherent with Government policy. Thus the way that the duties are being interpreted no longer reflect the right general policy balance. In the absence of a method of giving strategic direction Government is likely to, as it has done in the past, amend the functional duties of Ofgem. It is this scenario of persistent tweaking of the functional objectives of Ofgem that reduces predicatability. Further to this such changes have limited practical impact because they are open to wide interpretation.

The Guidance would still be the primary tool for outlining Government's more specific social and environmental goals to the regulator. Although not legally binding, this would continue to have a role in the regulatory framework, ensuring that the importance of the energy sector to achieving these wider objectives was set out in a public document. Government would be able to revise this Guidance on an ad hoc basis although it is subject to approval by Parliament.

As an alternative to amending the duties or Guidance, Government will continue to have the ability to take specific ad hoc powers regarding the regulatory regime in primary legislation, as it did in the Energy Act 2008 on the issue of transmission access. The use of such powers would need to meet the requirements of the EU Third Package. For example, the Government's use of its transmission access

⁴ We would not anticipate making changes to the existing framework except as required to ensure effective incorporation of the new policy. Duties relating to the Guidance would be removed if it were to be repealed. This would only be because these duties would then be redundant. Depending on the option chosen, a new duty around the legally binding Power to Direct or Strategy and Policy Statement would be introduced.

powers in 2009 was classified as a Public Service Obligation (PSO), which allows Government to intervene on pursuit of certain wider public interests.

Although the legal framework would be retained as above, under this scenario there would still be scope for improvements to the way in which it was applied. For example, encouraging more joint working where appropriate, building on informal processes where Government and GEMA can consider the future policy challenges that we face in the energy sector.

2. Establish a new ad hoc 'Power to Direct'

This option would replace or supplement the Guidance with an ad hoc power allowing the Government to set specific individual legally binding outcomes that the regulator must justify its actions against. As described above, the EU Third Package recognises that it is for Government to formulate strategic policy and for the regulator to take independent regulatory decisions. Therefore, we consider that it would be possible for Government to require the independent regulator to take its decisions within a defined strategic policy framework. The objective of successfully delivering the outcomes specified would provide the context for GEMA's regulatory decisions under its existing duties.

There would be constraints on the use of this power. For example, in setting outcomes Government would need to assess compatibility with the EU Third Package, consult with the regulator and lay the outcome before Parliament for approval (e.g. affirmative resolution) before it came into force. Government would also have to, at the very least, consult with GEMA to avoid unintended consequences and publish an impact assessment. To provide transparency as to the impact of the legally binding outcome, as well as accountability for delivery, the regulator would be required to set out what it plans to do and how it would monitor progress. They would also be required to report annually to Parliament 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. (See the following section on 'key policy design considerations' for further detail on constraints.)

Government would still retain its legal power to amend the existing framework (including statutory duties) and, in extremis, take specific regulatory powers in Primary legislation as long as they were compatible with the EU Third Package. Under this option, the Guidance could be repealed, although this decision would be subject to more policy analysis.

3. Establish a new 'Strategy and Policy Statement' (preferred option)

This option would replace the Guidance with a Strategy and Policy Statement. Like the Power to Direct, this document would be based on the principle that it is for Government to formulate strategic policy and that it is possible to require the regulator to take its decisions within that framework. This would be in addition to the current duties, which although functional do not set out clearly the strategic direction for the regulator. The Strategy and Policy Statement would include a set of policy driven outcomes that were legally binding on the regulator, as well as non-legally binding descriptions of the policy context and the roles and responsibilities within the regulatory framework, with particular reference to Government and the regulator. These outcomes would clearly make any trade-offs between competing policy goals that are appropriate for Government to make.

The outcomes would cover a broader policy spectrum than the Guidance to allow the consideration of issues such as security of supply and may, if suitable, be prioritised within the document. By providing these outcomes which GEMA must work to, the Strategy and Policy Statement offers a clear direction and scope within which GEMA can independently regulate in accordance with its duties. This Strategy and Policy Statement effectively narrows the scope of regulatory decisions that can be made by GEMA. This clearly sets out the policy decisions made by government and the scope within which GEMA will regulate, offering role clarity.

The outcomes set out in the Strategy and Policy Statement would be expected to remain stable over a Parliament and only subject to change if there was a significant development in policy. Any changes to the Strategy and Policy Statement would only apply to future decisions by GEMA and would not be applied retrospectively. Other process constraints, including those of EU law, the need to consult and the role of Parliament, would mirror those described under option 2, as would the process for holding the regulator to account against the outcomes specified. (Please see the following 'key policy design considerations' section for further details.)

Under this option, Government would still have the ability to amend GEMA's existing framework (including statutory duties) as well as, in extremis, use Primary legislation to take specific regulatory powers where compatible with the EU Third Package. However, the intention is that the establishment of

a Strategy and Policy Statement would prevent situations arising where the Government felt compelled to take such powers.

There will be a further impact assessment completed prior to the implementation of a specific Strategy and Policy Statement,

The Strategy and Policy Statement is our preferred option (please see costs/benefits below).

Costs and benefits of each option (including administrative burden)

Precise quantification of costs and benefits is problematic: in reality costs and benefits will depend on Government policy and the regulatory decisions taken by Ofgem. Consequently, the impact of these three options will primarily be non-monetised and the costs and benefits of each are described below within the context of the Principles described above and defined in Annex 2. It is important that the appropriate balance is struck between each of the Principles when setting the regulatory framework. The cost/benefit assessment also includes consideration of the resource needed to produce and operate within the proposed framework.

The discussion around options 2 and 3 describes the costs and benefits compared to the arrangements that we currently have in place (option 1). As many of the costs and benefits are non-quantifiable, it is important to note that any justification of a preferred option will rely on some subjectivity.

Table 1 below sets out the costs and benefits of Options 2 and 3, relative to Option 1. The costs and benefits of each option are subsequently summarised in the sections that follow.

Table 1: Summary of costs and benefits of Options 2 and 3, relative to Option 1

Principles	Option 1 – baseline position	Option 2 –change from Option 1	Option 3 –change from Option 1
Accountability	(Baseline) As described by the Call for Evidence responses, the existing legal framework has not provided sufficient opportunity for holding the regulator to account. The legally weak Guidance (to which GEMA only has to have regard) has contributed to roles being blurred and consumers, companies and investors being unsure as to who is responsible for what.	(+ / -) The legally binding Power to Direct would improve accountability in the policy area in which it was used. Government would be responsible for the trade-offs made in setting the outcome to be met. The regulator would be responsible for taking action to meet the outcome, reporting what it was doing and annually reporting to Parliament on its performance. The specific nature of this Power could be a drawback in terms of accountability, as it could focus minds, including of those holding the regulator to account, solely on the one or two policy areas where it has been used to the detriment of other policy goals. However, on balance, we think the Power would provide an improvement in	(+) The legally binding outcomes set out in the Strategy and Policy Statement would improve accountability across policy areas. It would provide a transparent vehicle for Government to make high-level policy trade-offs and would provide clear objectives for the regulator, against which they can be measured. As for option 2, the required annual reporting process would add to this. The non-binding 'policy context' and 'roles and responsibilities' sections of the document would be designed to clarify who does what within the energy market and why.

		accountability.	
Focus	<p>(Baseline)</p> <p>In general, stakeholders responding to the Call for Evidence felt that, where GEMA's remit was clear (e.g. around network regulation), the regulator was very effective and performed to a high standard. However, in those policy areas where responsibilities were less well defined the regulator has had to make trade-offs that were arguably for Government. The Guidance, introduced to reflect the importance of the energy industry to social and environmental policy goals, has not proved effective in clarifying the role of the regulator.</p>	<p>(+ / -)</p> <p>The Power to Direct would provide only some additional focus for the regulator in those policy areas where it is used. This would be a minor improvement on the current arrangements.</p>	<p>(+)</p> <p>Taken as a whole, the legally binding outcomes specified in the Strategy and Policy Statement would provide transparency as to the regulator's strategic focus across the regulated sector and remove some policy trade-offs from the regulator. However, in achieving this, it would place greater responsibility on the Government to get the content and balance of these outcomes right.</p> <p>The non-binding 'roles and responsibilities' section will also provide transparency for others as to what the regulator should be addressing.</p>
Predictability	<p>(Baseline)</p> <p>The weak status of the Guidance means that it has only provided some predictability to the energy market. However, any predictability has been outweighed by Government's ability to make changes to the principle objective and statutory duties on an ad hoc basis and, in extremis, the ability to take specific regulatory powers through primary legislation, where compatible with the EU Third Package. The lack of transparent process around these changes has increased uncertainty, as has a lack of clarity as to who should be responsible for key policy trade-offs.</p>	<p>(+ / -)</p> <p>Depending on how it was used, or expected to be used introducing an ad hoc Power to Direct could potentially add a further layer of uncertainty to the current regulatory regime. However, being able to specify legally binding and enduring outcomes that the regulator must justify its actions against should avoid further tinkering with the statutory duties, which we have assessed to be fit for purpose, and should also help to prevent scenarios where Government takes specific regulatory powers in primary legislation. Reducing the likelihood of these actions will have a positive effect on the market.</p> <p>The onus would be on Government not to overuse this Power, given that it would not require primary legislation. However, overall,</p>	<p>(+ / -)</p> <p>Replacing the Guidance with the outcomes in the Strategy and Policy Statement once a Parliament will provide increased transparency of the overarching strategic direction, energy policy and responsibilities. This will improve predictability and make changes through primary legislation, whether to the statutory duties or on specific regulation, much less likely.</p> <p>However, the ability for Government to also revise the Strategy and Policy Statement in the event of a 'significant development in policy' could create additional uncertainty. What is deemed to be 'significant' and how this ad hoc revision power is used in practice will be particularly important to encouraging investment in the GB energy system. Predictability may be</p>

		concerns about how government might use this power would likely reduce predictability in the market.	improved depending on how Government acts.
Coherence	<p>(Baseline)</p> <p>Ensuring coherence in the energy market has been the primary driver to the principle objective and changes made to the statutory duties over the last decade, as well as the revisions to the Guidance and, in extremis, the taking of regulatory specific powers by Government.</p> <p>While the ad hoc nature of these changes has not provided certainty, it has allowed Government to attempt to align the regulator with Government objectives. However, as noted by the Call for Evidence responses, the weak status of the Guidance has not been effective in making this alignment transparent or at setting out a clear accountability framework.</p>	<p>(+ / -)</p> <p>The Power to Direct would be used to improve coherence between Government strategy and the regulator's decisions in the particular policy area in which it was used. However, it might skew the regulator's focus, and that of those holding it to account, in a way that was detrimental to other policy areas. On balance, there should be a modest improvement in coherence.</p>	<p>(+)</p> <p>The Strategy and Policy Statement would be designed to improve coherence between Government strategy and the regulator's decisions. The set of outcomes specified would provide strategic alignment across all relevant policy for the period of a Parliament.</p> <p>The Strategy and Policy Statement would allow a new Government to make a clear statement of its strategic policy with the aim of avoiding a drip feed of changes subsequent to this.</p> <p>The ability to change the Statement in the event of a significant policy change is designed to ensure that the document does not become damagingly irrelevant, but does not provide the flexibility of the current arrangements.</p>
Adaptability	<p>(Baseline)</p> <p>The current arrangements are flexible, allowing ad hoc changes to the Guidance, GEMA's duties and, in extremis, specific regulation. Each process requires primary legislation, except the ability to review the Guidance, which is subject to approval by Parliament. Following its first publication in 2002, the Guidance was revised in 2004 and 2010.</p>	<p>(+)</p> <p>The introduction of the Power to Direct would allow Government to set specific outcomes that the regulator must achieve on an ad hoc basis. It would also be subject to approval by Parliament.</p>	<p>(+)</p> <p>The Strategy and Policy Statement, which will replace the Guidance, will be revised subject to approval by Parliament. It will be possible to do this on an ad hoc basis although, in practice, this is expected to be no more than once a Parliament, unless there is a need to reflect a significant policy change to ensure coherence across the regulatory framework.</p>
Efficiency	<p>(Baseline)</p> <p>The Call for Evidence responses noted that the regulator was particularly efficient in those areas</p>	<p>(+ / -)</p> <p>The setting of a Power to Direct outcome would, by definition, require Government to make key</p>	<p>(+)</p> <p>The Strategy and Policy Statement would involve Government making appropriate trade-offs</p>

	<p>where there was clarity and focus around its responsibilities.</p>	<p>trade-offs in the particular policy area and so provide greater clarity for the regulator. This greater focus will, in turn, provide greater certainty for the regulator to act on the specific issue.</p> <p>There may be a short period where efficiency at the regulator is reduced as any new arrangements bed down although it is not possible to quantify this effect.</p>	<p>across for energy policy relevant to the regulatory framework.</p> <p>Communicating this strategic policy to the regulator will, along with a clear statement of roles and responsibilities, reduce uncertainty and improve the regulator's focus. As described on the responses to the Call for Evidence, GEMA has been seen to be effective in those areas where it has this focus.</p> <p>There may be a short period where efficiency at the regulator is reduced as the new arrangements bed down.</p>
<p>Set-up and operational resource costs</p>	<p>(Baseline)</p> <p>There are costs borne by Government, associated with the periodic revisions to the Guidance (it was published in 2002, 2004 and 2010) as well as work on Energy Bills regarding amendments to the duties and the taking of regulation specific powers, if appropriate. With regard to such specific powers, there is also the cost to the Department of exercising them.</p> <p>There are costs to GEMA relating to its current reporting to Parliament and its annual Corporate Strategy, which sets out its goals.</p>	<p>(+ / -)</p> <p>DECC resource would be required to introduce the Power to Direct through primary legislation.</p> <p>The ongoing resource impact for DECC would depend on whether the Guidance was retained. If it were, additional resource would be required whenever it were decided to set a new outcome under the Power to Direct. The extent of this would depend on how many times this power was used.</p> <p>Resource costs to GEMA would be very similar, with the required reporting against the outcomes primarily integrated into existing reporting. The need to report annually to Parliament on performance would be an addition.</p>	<p>(+ / -)</p> <p>DECC resource would be required to introduce the Strategy and Policy Statement through primary legislation.</p> <p>There would be periodic costs to DECC associated with revising the Strategy and Policy Statement, but the discontinuation of the Guidance will mitigate this. Resource might be required if there was a significant change in policy that led to an ad hoc revision of the Steer but, overall, interventions should happen less often than under the Guidance. For example, if the Strategy and Policy Statement has its intended effect and Government no longer took regulation specific powers this would represent a resource saving to DECC.</p> <p>Resource costs to GEMA would be very similar, with the required reporting against the outcomes primarily integrated into existing reporting. The need to report annually to Parliament on performance would be an</p>

			<p>addition.</p> <p>The change to legal costs resulting from the introduction of the Strategy and Policy Statement would be expected to be neutral (see explanation under option 3 below).</p>
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1. Do nothing

This option would have a negligible impact on the issues around role clarity and accountability as, even if ways of working were improved, the underlying causes of the problems identified would remain, such as the weak legal status of the Guidance relative to GEMA's duties. There would also be a continued lack of clarity around the respective roles of Government and GEMA, which has undermined regulatory certainty and has the potential to become a much greater problem in the coming decades given the scale of change required if we are to meet our low carbon goals. This lack of certainty would exacerbate the challenge of securing the substantial investment required.

As noted in the table above, there are some strengths to the current arrangements stemming from the key principle of independent regulation, which would be retained in each of the three options. The Call for Evidence responses reflected the view that, in those areas where the regulator has a clear remit, it has been effective and has performed to a high standard. The existing framework has also been adaptable, with Government able to revise the duties and the guidance on an ad hoc basis, although this ability has also undermined any predictability provided by the weak legal status of the Guidance. Finally, any change brings with it risks of unintended consequences, and these would not arise if there was no change.

2. Establish a new ad hoc Power to Direct

This power would provide benefits to those policy areas where Government decides it needs to provide the regulator with greater clarity around the overarching strategic policy goals. As described in the table above, where the power is used, there would be greater confidence that the Government and the regulator are aligned and that this coherence would be enduring. It would also increase the regulator's focus and, potentially, its efficiency in the policy area where Government has made the appropriate trade-offs. The reporting arrangements against the specified outcome would provide transparency over the related actions of the regulator aiding accountability.

Although adding to the adaptability of the regulatory regime the introduction of the ad hoc Power to Direct could reduce predictability in the market depending on how it was applied. If it were to be used sparingly and yet its use avoided further changes to the existing framework (including the statutory duties) or Government taking specific regulatory powers then predictability in the market, and so investor certainty, would be improved. Using the Power only when it was really required would also minimise resource requirements at DECC.

As described above, in using the power, Government would need to be careful that it did not give rise to unintended consequences, including that of skewing the focus of the regulator as well as those, such as Parliament, that hold it to account. There is also a wider risk that the regulator's actions under a specified outcome could have unintended consequences for the energy market that were not anticipated. However, this could be mitigated by the requirement on Government to consult with the regulator before using the power.

3. Establish a new Strategy and Policy Statement (preferred option)

The Strategy and Policy Statement, which would be intended to remain stable over a Parliament, would arguably be less adaptable than the Guidance and the Power to Direct, which are defined as being ad hoc. However, the potential for a review should an issue of significance to Government's overarching policy goals arise, would provide an element of flexibility for an issue that genuinely required a change to the strategic direction. This flexibility, of course, has to be traded against the conflicting desire for

predictability and providing certainty for investors. During initial discussions around this potential policy option, investors that we have spoken to (in confidence) described this ability to ensure coherence between overarching strategy and the regulatory regime as 'sensible'.

Setting out this new 'strategic lens' through which the regulator then meets its existing functional duties and makes regulatory decisions may, as it takes time to bed down, impact on efficiency of the processes that support those decisions. However, over time, given that Government would have made decisions on a number of policy trade-offs, this arrangement should provide legal support to the regulator.

One of the main aims of the Strategy and Policy Statement would be to provide a transparent process through which Government can set out the strategic outcomes that it wants the regulator to contribute to within the wider policy context (Commitments 3 & 5). It would also be a vehicle for Government to make appropriate policy trade-offs, allowing GEMA to focus on its regulatory role in what is an increasingly complex market.

The Strategy and Policy Statement would provide a more transparent way to hold the regulator to account against the decisions that it makes (Commitment 4). Requiring GEMA to report to Parliament against the outcomes would help show how the regulator and Government are aligned at a strategic level, while retaining GEMA's independence on regulatory decisions (Commitment 2). Alongside the specified outcomes, the non-legally binding description of the broader policy context and the roles within the market would provide the required clarity around who, between the regulator and Government, is responsible for what in the energy market (Commitment 1). We have discussed the above with regulatory experts and some investors (in confidence) and there is general agreement that these characteristics of the Strategy and Policy Statement would be beneficial to the market.

It is possible that investors see this constraining of the regulator's discretion as a reduction of its independence and that Government may force the unravelling of past decisions. However, investors have been positive about the Strategy and Policy Statement including the flexibility to amend it if there are significant policy changes. As previously stated any changes to the Statement would only apply to future decisions by GEMA.

As noted in the above table, one potential concern relating to the resulting legally binding outcomes would be that their existence could have an effect on the levels of legal challenge. We note, however, that the introduction of a new duty to comply with the Strategy and Policy Statement would not increase the functions of GEMA (the exercise of which might be susceptible to challenge), but merely provide further constraints and guidance on the exercise of its existing functions. The Statement might, however, provide greater clarity about the trade-offs GEMA should be making when exercising its functions. This greater clarity offered by the Strategy and Policy Statement might allow companies to make better informed decisions about whether to legally challenge decisions by GEMA. This greater clarity should have two effects.

1. Those companies that previously overestimated the strength of any potential legal case and therefore in the absence of the Strategy and Policy Statement might have chosen to challenge GEMA would be less likely to initiate legal proceedings.
2. Those companies that previously underestimated the strength of any potential legal case and therefore in the absence of the Strategy and Policy Statement may have chosen not to challenge GEMA would now be more likely to initiate legal proceedings.

It is not possible to gather evidence on the relative size of these two groups of companies.

This is our preferred option as we expect this option to deliver best against the policy objective of reducing regulatory uncertainty for investors in the energy sector. This reduction in regulatory uncertainty has been assessed using the BIS principles for economic regulation as described above. As these costs and benefits to reducing regulatory uncertainty cannot be quantified we have to make a somewhat subjective decision. Based on the evidence presented above we expect the Strategy and Policy Statement to offer the best option.

Risks and assumptions

The preferred Strategy and Policy Statement option makes a number of assumptions and there will be risks to these assumptions:

- That that Government will be able to produce a coherent set of legally binding outcomes that the regulator will be able to contribute to and, where appropriate, be clear about the trade-offs to be made between them.
- That the legally binding outcomes on the regulator will not be seen by investors as eroding the regulator's independence.
- That the Government will be able to produce outcomes that do not have unintended consequences for the energy sector.
- That we are able to ensure that any review of the Strategy and Policy Statement is only initiated in the event of 'significant' changes to the policy landscape.
- That the independent regulator will work towards the legally binding outcomes to avoid being taken to court by a third party.
- That the probability of an increased frequency of legal challenge changing as a result of the Strategy and Policy Statement is negligible.
- That Government and the regulator are able to improve the way they work together as a result of other measures taken as part of the Ofgem Review. For example, ensuring an improved understanding at an individual level as to role of Government and the role of the regulator.

Direct costs and benefits to business calculations (following OIOO methodology) of preferred option (Option 3)

We have given a lot of consideration to the impacts of the Strategy and Policy Statement but, at this stage, it is not possible to quantify these. We will continue to explore this, and will reflect in future IAs which will accompany the Bill and implementation of the Statement. We have considered that there may be a number of non-monetised benefits in the form of a more stable and coherent regulatory environment. The only monetised or non-monetised costs that we consider may change are legal costs. On balance these are considered to remain unchanged. Our current best estimate is that there will be no change in direct costs to business.

There is the potential for a change in legal costs as discussed above. Any change in legal costs for GEMA would not represent a change in direct costs to business. In a previous DECC Impact Assessment⁵, we assumed, in line with advice from the Better Regulation Executive (BRE) that any change in costs to business associated with appealing a GEMA (Ofgem) licence modification would represent a direct cost to business. Hence, it seems reasonable to assume, for the purposes of this Impact Assessment, that any legal costs to business associated with challenging a GEMA decision would also represent direct costs to business. However, we believe that it is reasonable to assume that companies would only appeal when it was in their interest. We would therefore expect that businesses would only appeal when they believed that, given the probability of them winning a legal challenge, the benefits would outweigh the costs of the challenge.

The costs of appealing an Ofgem License Modification were estimated from a previous impact assessment.⁶ This impact assessment used a central estimate that an appeal against an Ofgem license condition would cost business £300k per appeal. While it might be possible to quantify the possible change in legal costs, we would not be able to quantify the benefits to challenge. However, if businesses did not expect these to exceed legal costs they would not pursue action in the first place. We have no firm evidence to suggest that there would be more or less appeals than under Option 1. There is logic explained previously to suggest that the number of appeals would be unlikely to change. Hence, our best estimate is that the proposal is an IN of size £0.

Key policy design considerations

What should be the process for establishing, reviewing and amending the Strategy and Policy Statement?

⁵ "Impact Assessment: Proposals for implementation of licence modification appeals under the EU Third Package", <http://www.decc.gov.uk/assets/decc/Consultations/eu-third-package/1161-ia-third-package-licence-mods.pdf>

⁶ <http://www.decc.gov.uk/assets/decc/Consultations/eu-third-package/1161-ia-third-package-licence-mods.pdf>

The answer to this question needs to strike an appropriate balance between the principles of focus, coherence, adaptability, predictability and efficiency.

The process for establishing, reviewing and amending the Strategy and Policy Statement needs to ensure that the regulator's role is appropriately articulated within the context of the Government's policy framework, and that the likely impact on the regulator's actions and consequences for the energy market are well understood. A robust process can also act as a constraint on Government and prevent unnecessary change.

Options include:

- Consultation with Ofgem and more widely with interested parties.
- Laying the Statement before Parliament, for example under either negative or affirmative resolution procedure.

While the Government would be the clear owner of the Statement, to ensure the Government fully understands the impacts of any change that is proposed, consultation with GEMA will be necessary and should be required under statute. It may also be appropriate to consult more widely, although this is likely to depend on the type of change being considered and so we think it best to consider this on a case by case basis.

To reflect the importance of the Statement and Parliament's role in scrutinising GEMA's activity, and to act as a constraint on Government, our current preference would be to establish the Statement under affirmative resolution procedure.

When should the Strategy and Policy Statement be reviewed?

The answer to this question needs to strike an appropriate balance between the principles of coherence, adaptability and predictability.

The Strategy and Policy Statement aims to ensure that there will be coherence between the Government's broader policy framework and the regulator's decisions. To maintain this coherence over time, the Statement will need to be adapted to reflect changing circumstances. To give predictability, those affected need to be able to anticipate the context for change.

Options include:

- Defining a timetable for regular review, for example every two, five or ten years.
- Defining the circumstances under which the Statement would be reviewed but not a timetable, for example where there is a significant change in policy.
- Defining a timetable for review that is linked to specific events, for example a new Parliament.

We have ruled out a timetable for regular review: policy developments, including those that are driven by Europe, do not occur on a regular timetable. So, to be confident that coherence with the policy framework would be maintained, reviews would need to be relatively frequent. While a review does not need to result in change, the perception would be that this is what would occur in practice, which would undermine stability.

So, our preference is for the Strategy and Policy Statement to be reviewed where there is a significant change in policy, following the process set out above that should act as a constraint on unnecessary change.

In practice, we might expect that a new Government would want to review the Statement and that the Statement would then remain stable over at least the length of the Parliament – although the option of reviewing and amending the Statement at any time would remain open.

What types of outcomes should the Strategy and Policy Statement specify?

The key principle here is coherence: the policy outcomes that the regulator is asked to justify its actions against must reflect the broader policy context. This means that the type of outcome will vary depending on the strategic policy context and could, for example, express a broad policy goal, identify specific issues or barriers, or define quantitative deliverables.

The underpinning principle, to support predictability, is that regulatory decisions that contribute to delivery of the policy goals are to be taken by the regulator independently of Government, as required under the EU Third Energy Package. The only possible exception to this is where there is a clear case for the Government to intervene in pursuit of certain wider policy interests by imposing a Public Service Obligation, which itself needs to be compatible with the EU Third Energy Package.

How will the regulator be held account against the outcomes specified?

The key principle here is accountability, which depends on transparency, a requirement to explain decision making, and exposure to scrutiny.

In some cases, delivery of a policy outcome specific in the Statement will be solely under GEMA's jurisdiction, in which case GEMA would be expected to demonstrate how it was delivering the outcomes. In others, GEMA will have an important role but hold only some of the levers and would not, on its own, be expected to ensure successful delivery but rather to articulate clearly its own role.

Options include:

- Allowing GEMA to establish its own processes for reporting against the Statement.
- Establishing formal reporting processes through legislation, which could for example require:
 - GEMA to set out its plans for delivering its contribution to the outcomes in the Statement, and how it will monitor progress.
 - GEMA to assess its progress against its plans, outlining and justifying decisions and, where progress is not on track, explaining why this was the case and whether any mitigating action was needed.
- Establishing informal processes through which Government and GEMA discuss plans and progress.

Greatest transparency, and an assurance that this will be enduring, would be best achieved by establishing formal reporting processes. To provide coherence across all Ofgem's activities, our preference would be for forward plans to be set out in GEMA's corporate strategy, on which they are already required to consult each year. To provide transparency on progress, our preference would be for a stand-alone report on progress each year.

These formal processes will be more effective if supported by informal engagement between Government and GEMA and we would, for example, expect Ministers to meet with GEMA to discuss progress and the challenges that we face.

Wider impacts

No direct wider impacts are anticipated from either Options 2 or 3. This includes impacts on equality, human rights and the justice system. However, indirect impacts might occur, depending on the precise content of any ad-hoc direction or Strategy and Policy Statement. For example there may be wider environmental (including greenhouse gas) impacts or competition impacts, depending on the weight that the Government of the day assigns to particular objectives. This impact assessment sits alongside the Ofgem review conclusions that set out the principle of the Strategy and Policy Statement. A further impact assessment will be completed before implementation, at which point costs/benefits will be assessed against the specific content of the Strategy and Policy Statement. The content will be subject to further discussion and a separate impact assessment.

Summary and preferred option with description of implementation plan

Summary

The Ofgem Review Call for Evidence found that stakeholders were generally supportive of the existing regulatory framework and the role of independent regulation within this. However, there were two areas where it was thought improvements could be made: role clarity between the Government and the regulator and the accountability of the regulator. The preferred option of a Strategy and Policy Statement would deliver against both of these.

The legally binding outcomes of the Strategy and Policy Statement would provide a transparent representation of the strategic policy framework as defined by Government. The non-legally binding sections would also make clear the roles of the regulator, Government and other organisations within the energy market, preventing misunderstandings as to who is responsible for which decisions. Requiring the regulator to explain on an annual basis how it would work towards the legally binding outcomes and, separately, report on its performance would improve transparency and the process of holding it to account against the overall impact of the decisions that it makes. In particular, Parliament would have a transparent and enduring framework against which to measure them. Limiting the re-issuing of the Strategy and Policy Statement to once a Parliament, unless there is a significant change to the policy landscape, would provide the right balance between predictability, adaptability and coherence.

Implementation plan

Implementing the Strategy and Policy Statement would require primary legislation. As well as repealing the provisions enabling the Secretary of State to give Social and Environmental Guidance it would be necessary to set out the following: the requirement on GEMA to justify its actions against the Strategy and Policy Statement (and how that fits with the current principal objective and statutory duties), what content could be included in the Strategy and Policy Statement, the legal status of this content, the constraints on Government for setting the content, including the arrangements for its revision, and the requirements on GEMA to report against the outcomes specified. The proposal would be to introduce at the earliest opportunity that Parliamentary time allows.

Annexes

- Annex 1 – Post Implementation Review (PIR) Plan
- Annex 2 – Government’s Principles for Economic Regulation

Annexes

Annex 1: Post Implementation Review (PIR) Plan

<p>Basis of the review: [The basis of the review could be statutory (forming part of the legislation), it could be to review existing policy or there could be a political commitment to review]</p> <p>A Post Implementation Review (PIR) would be held at the time of the first revision of the Strategy and Policy Statement in the next Parliament.</p>
<p>Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?]</p> <p>The PIR would review the effectiveness of the Strategy and Policy Statement against the policy objectives set out in this Impact Assessment.</p>
<p>Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach]</p> <p>In parallel to reviewing the content of the Strategy and Policy Statement according to the process set out primary legislation, DECC would take views and gather evidence on the principles behind its introduction.</p>
<p>Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured]</p> <p>The PIR will use the evidence collected as part of the Ofgem Review as the baseline for its assessment. For example, whether or not there have been improvements in terms of role clarity and accountability of the regulator.</p>
<p>Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives]</p> <p>Success would be measured through a number of indicators: no subsequent changes to the regulator's statutory duties; no regulatory specific power taken by Government; greater strategic alignment between Government and the regulator.</p>
<p>Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection of monitoring information for future policy review]</p> <p>This will be provided through the regulators reporting against the outcomes that it has been set and its performance against them</p>
<p>Reasons for not planning a PIR: [If there is no plan to do a PIR please provide reasons here]</p> <p>N/A</p>

Annex 2: Government's Principles for Economic Regulation

Accountability

- independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government
- roles and responsibilities between Government and economic regulators should be allocated in such a way as to ensure that regulatory decisions are taken by the body that has the legitimacy, expertise and capability to arbitrate between the required trade-offs
- decision-making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and subject to appropriate scrutiny and challenge

Focus

- The role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services by ensuring the operation of well-functioning and contestable markets where appropriate or by designing a system of incentives and penalties that replicate as far as possible the outcomes of competitive markets.
- economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focussed on outcomes rather than specified inputs or tools
- economic regulators should have adequate discretion to choose the tools that best achieve these outcomes

Predictability

- the framework of economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
- the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets

Coherence

- regulatory frameworks should form a logical part of the Government's broader policy context, consistent with established priorities
- regulatory frameworks should enable cross-sector delivery of policy goals where appropriate

Adaptability

- the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time

Efficiency

- policy interventions must be proportionate and cost-effective while decision making should be timely, and robust