

Ofgem Review Final Report

July 2011

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Ministerial Foreword



The Government remains committed to a framework of independent economic regulation for the energy sector and to Ofgem as the independent regulator. As regulator of the gas and electricity markets in Great Britain, Ofgem has a critical part to play in delivering a secure low carbon future at lowest cost.

Over the last two decades Ofgem, and its predecessors, have achieved significant savings for the consumer. We announced the Ofgem Review in July 2010 to ensure that, given the challenges we now face, the regulatory framework for the gas and electricity sectors would continue to deliver against our strategic objectives.

I believe the new statutory Strategy and Policy Statement that will be established as a result of this Review achieves this. It clearly places the responsibility for defining strategic direction with Government, providing the context for Ofgem's independent regulatory role, and giving confidence that the two will remain aligned and coherent.

Annexed to this report you will find a welcome contribution from Ofgem, addressing operational issues raised by some of those that responded to DECC's Call for Evidence. Looking forward, I hope that the conclusions of this review will further strengthen the relationship and dialogue between the regulator, Government and market participants. It is only by working together, within a strong and transparent regulatory framework, that we will be able to successfully deliver our energy and climate change goals.

A handwritten signature in black ink, appearing to be 'Chris Huhne'.

Chris Huhne MP
Secretary of State
Department of Energy and Climate Change

Acknowledgements

The Ofgem Review team would like to thank all those who have contributed to this Review, whether through their response to the call for evidence or discussions with the Review team. The team would also like to thank Ofgem for their constructive engagement throughout the Review, and in particular Richard Fawssett and Saf Ismail for their tireless assistance.

Executive summary

1. Independent regulation of the gas and electricity markets has been a cornerstone of energy policy ever since privatisation was initiated in the 1980s. By promoting competition in the gas and electricity supply and retail sectors, and replicating competition for the monopoly networks, economic regulation has delivered greater efficiencies and so lower consumer bills, as well as investment in energy services and infrastructure. These continue to be priorities but, given the changing energy policy landscape and the increasing focus on public policy priorities such as climate change, security of supply and fuel poverty, now is the right time to test whether the existing regulatory arrangements will be capable of meeting the challenges of the future.
2. The Coalition Programme for Government included a commitment to review the role of Ofgem, the independent economic regulator for the gas and electricity markets in Great Britain. In July 2010, DECC launched the Ofgem Review, with a focus on the energy regulatory framework¹ (rather than Ofgem E-Serve's delivery role). A call for evidence was published alongside², to which the Government published its response in December 2010³. A summary of the Review's findings was published in May 2011⁴, and this final report sets out the context for these conclusions in more detail.
3. The views collected from the call for evidence informed the scope of the Review. It was considered that the existing regulatory framework had provided good value for consumers and had attracted significant investment to the energy sector. However, there was a clear and consistent message about the need for greater role clarity between Ofgem and Government.
4. With the overarching aim of strengthening the regulatory environment in a way that would continue to protect consumers and enable cost effective investment in the energy sector, the Review therefore specifically 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; and
 - 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.

¹ Annual Energy Statement, DECC, July 2010:

http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/aes/aes.aspx

² Ofgem Review: Call for Evidence, DECC, July 2010:

http://www.decc.gov.uk/en/content/cms/consultations/ofgem_review/ofgem_review.aspx

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

http://www.decc.gov.uk/en/content/cms/consultations/ofgem_review/ofgem_review.aspx

⁴ Ofgem Review: Summary of Conclusions, May 2011:

http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/markets/regulation/regulation.aspx

5. The Government recently reaffirmed its commitment to independent economic regulation across the infrastructure sectors⁵. For the energy sector, where these arrangements are further reinforced by the requirements of the EU Third Package⁶, independence enables Ofgem to provide a stable regulatory environment for investors over the long term, important for securing investment in the UK as cost effectively as possible. As is made clear in the accompanying Electricity Market Reform White Paper, if we are to ensure future security of supply and decarbonise generation, we need to attract substantial new investment to the UK energy sector⁷ - up to £110bn in electricity generation and transmission alone in the next decade .
6. While the fundamentals of the regulatory system remain sound, the breadth of the contribution that the energy sector is now expected to make to wider policy goals and the scale of the challenge ahead has made the world of 2011 very different from that of the 1980s. 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. There is a need for an enduring solution that sees Government clearly taking responsibility for setting and communicating strategic direction, Ofgem's independent regulatory decisions forming a logical and coherent part of this broader strategic policy framework, and *ad hoc* interventions avoided where possible.
7. Consequently, to support a predictable regulatory environment over the coming decades, the Review has concluded that the Government should:
 - 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; and
 - define policy outcomes that Ofgem has an important role in delivering, or in helping to deliver, and seek legislative provision to require Ofgem to justify its independent regulatory decisions against these outcomes.
8. A new statutory 'Strategy and Policy Statement' will be established as soon as Parliamentary time allows. This Statement will set out the Government's policy goals for the gas and electricity markets; describe the roles and responsibilities of Government, Ofgem, and other relevant bodies; and define policy outcomes that Government considers Ofgem to have a particularly important role in delivering.
9. Ofgem will be expected to set out annually how it plans to deliver its contribution to each policy outcome and how it will monitor progress. In some cases the delivery of an outcome will be the sole responsibility of the regulator, while in others it will not hold all the levers and will need to articulate its own contribution. Ofgem will also be expected to report annually on progress, outlining and justifying decisions and, where progress is not on track, explaining why and what mitigating action might be needed.

⁵ Principles for Economic Regulation, BIS, April 2011:

<http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation>

⁶ EU Third Internal Energy Market Package, European Commission:

http://ec.europa.eu/energy/gas_electricity/legislation/third_legislative_package_en.htm

⁷ Electricity Market Reform White Paper, DECC, July 2011

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10. The Strategy and Policy Statement will be intended to remain stable over at least the length of a Parliament. However, 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 Statement should there be a significant change in policy.
 11. Good corporate governance will be essential for effective implementation of the Strategy and Policy Statement, which will provide a new focus for Government and GEMA (Ofgem's board) to consider the challenges ahead for the energy sector. The Review has concluded that the existing unitary model of governance is best suited for Ofgem's purposes although GEMA's membership could be strengthened by the appointment both of a non-executive with expertise in economics during the next round of recruitment and of Ofgem's finance director as an executive member.
 12. The operational behaviours of DECC and Ofgem, both in how we work together and how we work independently, are key factors that will underpin the effectiveness of the regulatory framework in future. Annex A sets out Ofgem's own conclusions on issues that were raised during the Review in relation to their operational effectiveness.
 13. Following the publication of the Ofgem Review's conclusions in May 2011, this final report explains in more detail the context within which the Review was conducted and the options that were considered, and sets the scene for the introduction of the Strategy and Policy Statement through primary legislation as soon as Parliamentary time allows.

Part 1: The context for the Review

Independent economic regulation

14. Energy supplies need to be secure, sustainable and affordable. The current energy market framework, like other utilities sectors in the UK, uses competition, shaped and supplemented by regulation, to deliver these objectives.
15. The gas and electricity industries were privatised some twenty years ago and, at the same time, a system of independent economic regulation was established. The energy sector had previously been run by state-owned monopolies, but this arrangement was challenged by the then government's social and economic policy. It was considered that the nationalised monopoly industries should be reformed in order to increase productivity, efficiency and innovation, and momentum gathered behind the idea that significant improvements could be delivered through competitive markets and regulation of monopoly markets. This would meet the desire to encourage efficiencies, to increase security of supply through greater diversity of fuel source, and to have industry take the lead in planning the future shape of production and consumption.
16. Privatisation of the gas and electricity sectors in Great Britain was realised through the Gas Act 1986 and the Electricity Act 1989. The same Acts also created the Director General of Gas Supply and the Director General of Electricity Supply and led to the formation of Ofgas, the Office of Gas Supply, and OFFER, the Office of Electricity Regulation^{8,9}. These two economic regulators were established as independent from Government, accountable instead to Parliament, in order to separate their regulatory decisions from political control and so provide greater long term regulatory certainty and to encourage market entry and investment.
17. The Gas and Electricity Markets Authority (GEMA) was created under the Utilities Act 2000, formed by a merger of the functions of the Director Generals of Gas Supply and Electricity Supply. The Office of Gas and Electricity Markets (Ofgem) was established as GEMA's executive arm. Today, Ofgem¹⁰ continues to regulate the gas and electricity networks and the competitive markets in gas and electricity supply and retail. The protection of consumer interests lies at the heart of the regulator's role, including those interests in reducing greenhouse gas emissions and security of supply.
18. Competition is generally accepted as the most efficient method to deliver optimal outcomes for consumers and so continues to sit at the heart of the economic regulation model. Since privatisation, the regulators have introduced, and actively promoted, competition in gas and electricity supply and retail markets, metering, extensions to onshore distribution networks, and offshore electricity transmission.

⁸ This energy market legislation followed the creation of the first UK economic regulator, the Director General of Telecommunications and its executive arm Oftel (the Office of Telecommunications), in the Telecommunications Act 1984.

⁹ Northern Ireland has its own energy market arrangements, overseen by the independent utilities regulator NIAUR (Northern Ireland Authority for Utility Regulation).

¹⁰ Note that both here and in subsequent references to Ofgem as the regulator should be read to include GEMA.

19. Competition is not, however, always the optimal approach. In certain circumstances, businesses may be incentivised to collude, merge with other firms to gain a dominant position, or abuse a dominant position. The general framework of competition law provides tools for the competition authorities, including Ofgem, to address these problems. Furthermore, the gas and electricity networks at the time of privatisation were considered to be ‘natural monopolies’ because introducing full competition would see an inefficient duplication of infrastructure. The regulators have instead used their powers to ensure that consumer benefits that would otherwise arise from competition are delivered.
20. Similarly, even where competition is the best approach, it may produce imperfect outcomes: competitive utility markets rarely operate perfectly in line with economic theory so the regulator must be vigilant in promoting and protecting competition. Nor will markets necessarily deliver in line with wider public interest objectives – such as protection for vulnerable consumers, or compliance with environmental and safety objectives – and regulatory intervention (or government measures) can correct these failures.
21. These arrangements have delivered significant benefits for energy consumers over the years, and they continue to be the best foundation for delivering value for domestic and business consumers; encouraging innovation in technologies and products; and delivering efficiency and quality.
22. The role played by independent economic regulation in realising these benefits has been widely acknowledged¹¹ and, following the 2009 adoption of the EU Third Internal Energy Market Package (‘EU Third Package’) this model is now being rolled out across Europe¹². In the UK, the Government recently reaffirmed its commitment to independent economic regulation and went further by publishing its own ‘Principles for Economic Regulation’ (see box 1)¹³. These Principles underpinned the analysis of the options considered by the Ofgem Review.

Box 1: The 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.

¹¹ Ofgem Review: Call for Evidence – A Government Response, DECC, December 2010:

http://www.decc.gov.uk/en/content/cms/consultations/ofgem_review/ofgem_review.aspx

¹² EU Third Internal Energy Market Package, European Commission:

http://ec.europa.eu/energy/gas_electricity/legislation/third_legislative_package_en.htm

¹³ Principles for Economic Regulation, BIS, April 2011: <http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation>

Box 1: The Government's Principles for Economic Regulation

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.

The changing energy policy landscape

23. When the process for privatising the gas and electricity sectors began in the 1980s, and economic regulation first established, the focus was on meeting consumer interests by seeking greater efficiencies, which would be reflected in consumers' energy bills. In the subsequent decades, there have been substantial shifts in the policy landscape, which mean that the energy sector, and so the energy regulator, is now expected to contribute to a much broader range of public policy goals.
24. For example, in 1992 the UK made its first commitment to reduce greenhouse gas emissions when it signed up to the Rio Framework Convention on Climate Change and agreed to aim to return UK greenhouse gas emissions to 1990 levels by 2000. By 2008, this had become a legally binding domestic commitment to reduce UK emissions to 80% below 1990 levels by 2050. As the energy sector accounted for 35% of the UK's emissions in

2009¹⁴, delivery of this goal has major implications for the way that we supply and use energy in the UK.

25. In parallel, specific goals relating to renewable energy have been established. While the Electricity Act 1989 introduced the Non-Fossil Fuel Obligation, which encouraged growth in the renewables energy industry, the targets established since imply a completely different level of ambition. By 2008, the UK had signed up to deliver its share of an EU renewables target for 2020. This will see the UK deliver 15% renewable energy across the electricity, heat and transport sectors, implying some 30% renewable electricity.
26. A parallel challenge has been the changing picture on energy bills that, for domestic consumers, saw a real terms fall following privatisation, before starting to rise again in 2004¹⁵. This was driven by a range of factors but in particular rising global fossil fuel prices. To help address the associated social consequences, the Government set targets for reducing fuel poverty.
27. DECC's 2050 Pathways Analysis¹⁶ provides a model within which to consider some of the energy choices and trade-offs this country will need to make over the next forty years if our low carbon and security of supply objectives are to be met. Unsurprisingly, to meet these goals, the model predicts significant changes for the energy sector in the coming decades. Key challenges for the energy sector could include:
 - the need to significantly reduce energy demand per capita;
 - a substantial level of electrification of heating, transport and industry;
 - electricity supply may need to double by 2050, and will need to be decarbonised;
 - more intermittent (e.g. wind) and inflexible (e.g. nuclear) generation will increase the challenge of balancing the grid;
 - sustainable bio-energy will be important in those sectors where electrification is not viable; and
 - there will be an ongoing need for fossil fuels, although exact use will depend on the success of technologies such as carbon capture and storage (CCS).
28. It is the responsibility of Government to establish strategic goals such as these, and to ensure that an appropriate framework is in place to enable delivery. For example, the Electricity Market Reform White Paper, which is published alongside this report, sets out a package of policies that will ensure the future security of electricity supplies and drive the decarbonisation of our electricity generation, at least cost to the consumer (see Box 2).
29. In designing a delivery framework Government needs to ensure that other public bodies are able to play their role. The transformation of the gas and electricity sectors will continue to be key to the delivery of the Government's strategic goals and the role of the regulator in meeting these challenges needs to be properly understood if we are to ensure a fit for purpose regulatory framework for the future.

¹⁴ UK Climate Change Sustainable Development Indicator: 2009 Greenhouse Gas Emissions, Final Figures. DECC. 2011.

¹⁵ Quarterly Energy Prices, DECC. <http://decc.gov.uk/en/content/cms/statistics/publications/prices/prices.aspx>

¹⁶ 2050 Pathways Analysis, DECC. http://www.decc.gov.uk/en/content/cms/what_we_do/lc_uk/2050/2050.aspx

Box 2: Electricity Market Reform White Paper

Around £110bn investment in new generation and transmission infrastructure is needed over the next decade as over a quarter of our existing generation capacity is expected to close. Electricity Market Reform (EMR) will put in place the framework to deliver this investment and, in doing so, will ensure the future security of electricity supplies and drive the decarbonisation of our electricity generation, at least cost to the consumer. The EMR White Paper is published in July 2011, alongside this report, and includes:

- the introduction of a **Carbon Price Floor (CPF)** to reduce investor uncertainty, put a fair price on carbon and provide a stronger incentive to invest in low carbon generation now. This was announced in Budget 2011.
- the introduction of **new long-term contracts** (a Feed-in Tariff with Contracts for Difference) to provide stable financial incentives to invest in low-carbon electricity generation.
- an **Emissions Performance Standard (EPS)** set at 450g/kWh to provide a clear regulatory signal that new coal plants must limit their emissions.
- a **Capacity Mechanism** to ensure future security of electricity supply. The Government is seeking further views on the mechanism required and will report on this toward the end of the year.
- this will be underpinned by a strategy for **future electricity networks** and work led by Ofgem to **improve market liquidity**.

Challenges for energy regulation

30. The Review needed to understand the types of challenges that the regulator might face in the coming years in order to ensure that the regulatory framework would be robust to future changes. This section provides a summary of some of the key issues.
31. **The electricity sector:** to meet the challenges outlined in the previous section all parts of the electricity sector will need to evolve over the coming decades and most, if not all, developments will require major investment. Through its regulation of the networks in particular, the regulator will play a crucial role in ensuring that this investment is focussed on meeting those challenges and delivered as cost effectively as possible for consumers.
32. Since the privatisation of the networks the regulators have used regular price controls as a proxy for competition for the onshore transmission and distribution networks. These price controls set the maximum amount of revenue that an electricity or gas network owner can take through the amount it charges users of the grid. From this revenue the network company should be able to meet its costs and make a return within agreed estimates.

33. Following a two-year review of the network price control process, Ofgem has introduced a new model called RIIO (revenue equals incentives plus innovation plus outputs)¹⁷. This has been designed with future challenges in mind, including the need to promote smarter grids to achieve our low carbon future. For example, transmission networks will require reinforcement to enable electricity supply generated in new locations to flow through the system. In the case of electricity distribution networks, investment will be required to facilitate Demand Side Response (DSR) technologies, such as electric vehicles, distributed generation and electric heat. These innovations will potentially provide a cost effective approach to balancing supply and demand but will require upfront investment.
34. A successful offshore transmission network will facilitate key future technologies such as wind power as well as greater interconnection with Europe. Unlike onshore, the offshore network regime has been set up under a competitive model in order to provide cost effective connections for generators¹⁸. With licences to own and maintain (and construct, where appropriate) these offshore networks being granted on a competitive basis, Ofgem will need to use its regulatory powers effectively to ensure that the interests of consumers and renewable generators are met.
35. The regulator will need to ensure that competition in the wholesale market continues to be effective, delivering competitive prices and security of supply. The EMR White Paper proposes the introduction of new market interventions and, while under those proposals the fundamentals of the market structure would remain the same, the regulator would need to monitor the impacts on market participants and consider whether there would be a need for any complementary regulatory actions. The proposals for improving liquidity in the wholesale market included in Ofgem's Retail Market Review proposals¹⁹ are one important example of this.
36. **The gas sector:** Although gas demand is currently projected to remain broadly constant over the next 15 years²⁰ there are a number of uncertainties around these projections. These include the actual trajectory of demand from the generation sector in future years and the speed at which we are able to drive decarbonisation of heat, including through the electrification of heat. Such uncertainties potentially have important implications for long-term investment in gas infrastructure.
37. In the past Ofgem has helped facilitate greater diversity of gas supply including interconnector pipelines with Europe and connecting liquefied natural gas (LNG) import capacity to the network. Looking ahead, the question around future investment will have significant implications for the price control regulation of gas networks and will need careful handling. Ofgem will need to continue to incentivise and optimise the appropriate amount of gas supply infrastructure in a changing world - for example, taking into account the potential role of non-conventional sources, such as bio-methane.
38. **Consumer protection and retail market competition:** Against the backdrop of the

¹⁷ RIIO, Ofgem, October 2010. <http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx>

¹⁸ Offshore network development, DECC, 2011.

http://www.decc.gov.uk/en/content/cms/meeting_energy/network/offshore_dev/offshore_dev.aspx

¹⁹ Retail Market Review, Appendix 2, Ofgem, 2010/11.

<http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Pages/rmr.aspx>

²⁰ Statutory Security of Supply Report, DECC & Ofgem, November 2010.

http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/resilience/sec_supply_rep/sec_supply_rep.aspx

challenges outlined above, consumer protection will also require careful monitoring.

39. Increased worldwide pressure on oil and gas resources, coupled with the investment required to realise a secure and low carbon future, are widely expected to result in higher energy prices. Government policies such as the Green Deal²¹, Energy Company Obligation, Warm Home Discount and Winter Fuel Payment will help mitigate the impact of these higher prices on domestic energy bills. The regulator will also need to play its part both in considering what costs should be placed on today's consumers in return for the benefits that new investment will bring, and in ensuring that the energy markets are operating in the best interests of all consumers.
40. It is estimated that, over the next decade, up to £110bn of investment in electricity generation and transmission will be needed if we are to ensure future security of supply and the decarbonisation of generation. Through its network price controls Ofgem will play an important role in incentivising such investment, balancing the long term consumer benefits with the cost to the current consumer. In facilitating this transition to a low carbon economy the regulator will also need to help ensure that it happens at least cost.
41. The key mechanism available to Ofgem in protecting consumers is through ensuring that the competitive energy markets are operating effectively. In 2008 Ofgem used its regulatory powers to conduct an Energy Supply Probe²². This was launched in response to growing public concern over the competitiveness of gas and electricity retail markets. In order to address those concerns the regulator investigated the customer's experience of the market, the market share of individual suppliers, the competitiveness of pricing, the relationship with the wholesale markets and the economics of new entry. Although the probe found that the market was generally working well, it did identify that competition was not yet fully effective in all parts of the market and put forward a package of measures to improve the existing arrangements. These included amendments to supplier licences around the terms and conditions they offered consumers, the information they provided and the way in which they conducted their sales activities.
42. The Energy Supply Probe has since been followed up by the regulator's Retail Market Review²³ for which the findings and initial proposals were published in March 2011. As well as addressing the issue around wholesale market liquidity (see above), these proposals are further targeted at making it easier for consumers to play their part in the market. For example, by making it easier to identify who is offering the cheapest tariff.
43. The kinds of consumer related issues identified in the probe and subsequent review will continue to be important in the coming decades, particularly as the methods of matching supply and demand develop. For example, smart metering is to be rolled out to all households by 2019, allowing real time monitoring of electricity and gas consumption. This will create new market opportunities offering benefits to consumers. However, careful regulation will be required if this new technology is to meet its full potential. As smart meters and other DSR technologies are rolled out with a view to meeting our low carbon targets, it will be paramount to keep consumers engaged in the market. The regulator's role in

²¹ The Green Deal, DECC.

http://www.decc.gov.uk/en/content/cms/what_we_do/consumers/green_deal/green_deal.aspx

²² Energy Supply Probe, Ofgem, 2008.

<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Pages/Energysupplyprobe.aspx>

²³ Retail Market Review, Ofgem, 2011. <http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Pages/rmr.aspx>

protecting the interest of the consumer will be central to this.

44. **Wider regulatory challenges:** In future, there may be other regulatory challenges in the energy sector that will have to be tackled, either by Ofgem or another body. For example, the Government has already committed up to £1bn for CCS demonstrations and the Coalition Agreement sets out its intention to support further demonstrations²⁴. This technology may be vital to meeting the UK's commitment of reducing greenhouse gas emissions to 80% of 1990 levels by 2050. Demonstration and deployment of CCS could require the reuse of assets currently subject to regulation by Ofgem. The widespread deployment of CCS could also require investment in a network of pipelines similar in scale and coverage to the existing gas network. The arrangements for regulating such a network will be kept under review.
45. Heat and cooling accounts for a significant proportion of the UK's total final energy consumption and nearly half of CO₂ emissions. Decarbonising the supply of heat across all sectors is therefore an essential component of reducing emissions by 80%, and will have important implications for gas and electricity markets. Potential solutions include electrification of heat through use of heat pumps, low carbon or renewable combined heat and power and increased use of district heating²⁵. The Government is therefore considering what we should be doing now and through the next decade in order to ensure the supply of low carbon, secure and affordable heat (and cooling) for homes, businesses and industry. In March, the Government announced the details of the Renewable Heat Incentive (RHI) policy, which is the first financial support scheme for renewable heat of its kind in the world. This will complement the proposed Electricity Market Reform, in particular by helping to support system balancing through access to efficient heat storage facilities and heat distribution infrastructure at the local or district scale. Depending on the future scale of heat technology deployment, there may need to be developments in regulation regarding the way the networks are run and the way that heat is sold on the retail market.

²⁴ Carbon Capture and Storage, DECC:

http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/energy_mix/ccs/ccs.aspx

²⁵ Heat, DECC: http://www.decc.gov.uk/en/content/cms/meeting_energy/microgen/microgen.aspx

Part 2: Ofgem Review: scope and process

46. The Coalition Programme for Government included a commitment to review the role of Ofgem. In July 2010, the DECC Secretary of State launched the Ofgem Review, with a focus on the energy regulatory framework²⁶ (rather than Ofgem E-Serve's delivery role). A call for evidence was published alongside, seeking views on a wide range of issues that the Review could explore including the Government's objectives for independent regulation of the energy sector, the boundary of responsibility between Ofgem and Government and between Ofgem and OFT, the statutory framework that Ofgem works within, the value for money provided by Ofgem and its approach to minimising regulatory burdens²⁷. DECC received 66 responses and we are grateful for the time and thought put in by all concerned.
47. The Government published a response to the call for evidence in December 2010, which recognised the strengths of the existing regulatory framework and confirmed a commitment to independent regulation of the energy sector²⁸. Although there was support for the existing regulatory framework from those who responded, there were also a number of issues raised, with some clear and consistent messages. In response, the Review focussed on the following key issues.
48. **Role clarity:** it was considered that, as a priority, the Review should look at the clarity of the role of the regulator and, in particular, how that role should relate to that of Government. The increasing importance of social and environmental policy in the energy sector, on top of the regulator's remit to ensure economic efficiency, had caused a blurring of responsibilities and some erosion of the regulatory certainty that independent regulation had been designed to provide. The complexities of the energy market landscape are not going to go away and, in the future, it will be important to ensure that the regulatory regime is coherent with strategic policy direction in a way that is both effective and transparent to market participants. In considering options for implementing any conclusions on roles and responsibilities, the Review would look at the legal framework that defines the regulator's role and powers.
49. **Governance and accountability:** responses to the Call for Evidence suggested that, in order to improve certainty in the market and give confidence on value for money, both the way that others scrutinise and challenge Ofgem's work and the way that Ofgem itself explains its strategy and decisions, needed to be more robust and transparent. Consequently, the Review would consider ways in which the existing arrangements, based around the regulator's accountability to Parliament, might be strengthened. As good governance is fundamental to any organisation, the Review also went back to first principles in exploring option for optimising Ofgem's corporate governance structures.
50. **Ways of working:** the call for evidence raised a number of operational issues relating to the

²⁶ Annual Energy Statement, DECC, July 2010:

http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/aes/aes.aspx

²⁷ Ofgem Review: Call for Evidence, DECC, July 2010:

http://www.decc.gov.uk/en/content/cms/consultations/ofgem_review/ofgem_review.aspx

²⁸ Ofgem Review: Call for Evidence – A Government Response, DECC, December 2010:

http://www.decc.gov.uk/en/content/cms/consultations/ofgem_review/ofgem_review.aspx

way that Ofgem and the Government worked. Some issues around role clarity were to be taken forward jointly, while others would be for each organisation to consider independently.

51. The Review received a range of views on the effectiveness of the arrangements whereby Ofgem holds some of its powers for competition and consumer protection concurrently with OFT. The same arrangements apply in other regulated sectors (e.g. water, communications) and it was decided that consideration of these issues would be taken up within the context of the Government's broader work on the competition regime, which is led by BIS. The concurrent competition powers held concurrently by the sector regulators (e.g. Ofgem, Ofwat, Ofcom) and OFT are being examined as part of the public consultation on the government's proposal to merge the Competition Commission and OFT.
52. In further exploring the issues highlighted above, the Review aimed to strengthen the regulatory environment in a way that continued to protect consumers as well as enable energy sector investment to be secured as cost effectively as possible. More specifically, the Review 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; and
 - 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.
53. Options for change were assessed against the Principles for Economic Regulation (see Box 1) and the review team further tested their thinking through informal discussions with representatives from industry, consumer groups and investors prior to publishing a summary of the Ofgem Review conclusions and accompanying impact assessment in May 2011²⁹.

Related Government projects and their status

54. The Ofgem Review has been operating in a crowded policy landscape and the conclusions take account of a number of complementary strands of work. Key among these are:
55. **Delivery Review (DECC):** Announced alongside the Ofgem Review in the July 2010 Annual Energy Statement, the Delivery Review considered DECC's relationship with its delivery partners, including Ofgem E-Serve. The Delivery Review's report³⁰ was published in May alongside the conclusions of the Ofgem Review.
56. **Electricity Market Reform (DECC):** This Ofgem Review final report has been published alongside the Electricity Market Reform White Paper, which sets out a package of policies that will ensure the future security of electricity supplies and drive the decarbonisation of our

²⁹ Ofgem Review: Summary of Conclusions, May 2011:

http://www.decc.gov.uk/en/content/cms/what_we_do/uk_supply/markets/regulation/regulation.aspx

³⁰ The Delivery Review, DECC. May 2011,

<http://www.decc.gov.uk/en/content/cms/about/partners/review/review.aspx>

electricity generation, at least cost to the consumer³¹.

57. **The Principles for Economic Regulation (BIS):** Published in April³², these Principles provided the framework for assessing the options considered as part of the Ofgem Review.
58. **The Ofwat Review (Defra):** The Ofwat Review was carried out in parallel with the Ofgem Review, with a similar scope and timeline. Conclusions were published on 6 July³³.
59. **Review of the competition and consumer landscape (BIS):** The Government has proposed a number of reforms to the current institutional arrangements for regulation of competitive markets³⁴ and consumer protection³⁵, with consultations published in March and June respectively.
60. **The National Infrastructure Plan (Infrastructure UK, HMT):** Published in October 2010, the NIP set out Government aspirations for investment in infrastructure across all sectors³⁶. The next iteration of the Plan will be published in the autumn.

³¹ Electricity Market Reform White Paper, DECC, July 2011.

³² Principles for Economic Regulation, BIS, April 2011: <http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation>

³³ Review of Ofwat and consumer representation in the water sector, Defra, July 2011.

³⁴ A Competition Regime for Growth: A Consultation on Options for Reform, BIS, March 2011

³⁵ Empowering and protecting consumers, BIS, June 2011.

³⁶ National Infrastructure Plan, IUK, HMT, October 2010: http://www.hm-treasury.gov.uk/ppp_national_infrastructure_plan.htm

Part 3: Conclusions and discussion

Role clarity: a new statutory Strategy and Policy Statement

Background: the legal framework

61. As for other economic regulators in the UK, Ofgem's functions and powers are defined in statute. These functions and powers set the context for all regulatory decisions and, as described above, were initially set out in the Gas Act 1986 and the Electricity Act 1989. Amendments and additions have been made through subsequent primary legislation.
62. When making its day-to-day decisions, the regulator will consider its principal objective, duties, guidance from Government, and any public service obligations. Failure to work within this statutory framework could result in legal challenge.
63. **The Principal Objective:** The Utilities Act 2000 established an overarching principal objective for energy regulation, defining the purpose of Ofgem's activities as to protect the interests of existing and future consumers, wherever appropriate by promoting competition. This clear focus on consumers was introduced as part of a wider package of social policy proposals³⁷.
64. The Energy Act 2010 amended the principal objective to clarify that the interests of consumers should be taken as a whole, including their interests in the reduction of greenhouse gas emissions and ensuring security of supply. These clarifications reflected the direction of the Government's strategy for the energy sector.
65. **Statutory duties:** Ofgem's duties require them to consider a number of issues in furthering their primary objective to protect consumers. These duties have been amended a number of times, reflecting changing Government priorities. Box 3 sets out the duties as they were for the gas sector in 1986, and Box 4 as they are today. Those for the electricity sector are now essentially identical and have evolved in a similar way. Changes have included the introduction of the principal objective in 2000: prior to this explicit mention of consumer interests appeared only in the secondary duties. Meanwhile, the duty to contribute to sustainable development was first introduced by the Energy Act 2004 as a secondary duty, and subsequently promoted to a primary duty in the Energy Act 2008, reflecting the Government priorities.

³⁷ A Fair Deal for Consumers – Modernising the Framework for Utility Regulation, DTI, 1998, <http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/urt/fairdeal/part1.htm>

Box 3: Summary of the regulator's statutory duties as they were when first established under the Gas Act 1986

Primary duty:

To exercise functions in the manner best calculated to secure:

- that all reasonable demands for gas are met so far as it is economical to do so;
- that companies are able to finance gas supply services.

Secondary duties:

Subject to the primary duty, to exercise functions in the manner best calculated to:

- protect the interests of consumers in respect of prices charged as well as other terms of supply, continuity of supply and the quality of gas supply services;
- promote efficiency and economy of the supply companies and efficient use of gas;
- protect the public from dangers arising from transmission, distribution or use of gas; and
- enable competition in supply to premises using more than 25,000 therms per year.

When exercising functions in the manner best calculated to protect the interests of consumers in respect of quality of gas supply services, the regulator must take into account in particular the interests of those who are disabled or of pensionable age.

Box 4: Summary of the regulator's statutory duties as they are today, under the Gas Act 1986 as amended

Principal objective:

To protect the interests of existing and future consumers where, taken as a whole, those interests include the reduction of greenhouse gases and security of supply.

Primary duties:

The regulator has a duty to:

- carry out functions in the manner which it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition; and
- consider how far promoting competition would protect consumers and whether there are alternatives that would better protect interests,

Having regard to:

- the need to secure that all reasonable demand is met where economical to do so;
- the need to secure that companies are able to finance activities;
- the need to contribute to the achievement of sustainable development.

Box 4: Summary of the regulator's statutory duties as they are today, under the Gas Act 1986 as amended

In carrying out the primary duties the regulator must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes or live in rural areas, as well as to those of other consumers.

Secondary duties:

The regulator shall, , subject to primary duties, carry out functions:

- in manner best calculated to:
 - promote efficiency and economy;
 - protect the public from dangers;
 - secure a long term energy supply.
- having regard to effect on the environment.

Other:

The regulator has the discretion to have regard to the interests of consumers in relation to communications services and electronic communications apparatus or water/sewerage services and electricity (or gas in the case of the Electricity Act 1989).

In carrying out all functions in accordance with the primary and secondary duties, the regulator must have regard to the need for best regulatory practice and regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.

The duties for the electricity sector are essentially mirrored in the Electricity Act 1989, as amended.

66. **The Social and Environmental Guidance:** The Utilities Act 2000 introduced a requirement for the regulator to 'have regard' to Government issued guidance on social and environmental policies. The rationale for establishing this Guidance came from a concern that the existing regulatory framework did not fully reflect the increasing role of the energy sector, and its regulation, to the achievement of wider policy objectives. Given its status as 'guidance' it provided context within which Ofgem could make its decisions, rather than any specific direction.

67. First issued in 2002, the Guidance was subject to revision in 2004 and 2010. A somewhat different approach has been taken to the guidance each time it has been produced, but it has always described the Government's high-level social and environmental policy objectives for the energy sector as they were at the time and considered the contribution of Ofgem. So, for example, the 2004 guidance reflected the strategy set out in the

Government's 2003 low carbon economy White Paper³⁸.

68. **Public Service Obligations:** The EU Third Package, adopted in 2009, sets out rules for facilitating the liberalisation of energy markets across the European Union. The EU Third Package allows governments to impose direct requirements on energy companies through a Public Service Obligation (PSO). A PSO can be used only in particular circumstances, such as on issues of security or environmental protection, including energy efficiency, climate protection and promoting energy from renewable sources. PSOs also have to meet certain criteria, such as being transparent and non-discriminatory.
69. Transmission access provides a recent example of a PSO³⁹. Government used this mechanism to embed its proposals for enabling new generators access to the electricity network. This was done on the basis that the proposals would support the UK in meeting its renewable energy targets and enhance security of supply. As in this case, given the existing regulatory framework, introducing any future PSO would also be likely to need domestic legislation to be effective.

Background: roles and responsibilities

70. **The role of Government:** Through its democratic mandate, it is the role of Government to set strategy and policy for the energy sector and, where necessary, to facilitate the achievement of these policies through the use of its legislative powers. Through these powers, the Government seeks to minimise barriers to achieving its goals, and to incentivise behaviours that support delivery. For example, the measures set out in the Electricity Market Reform White Paper seek to provide effective financial incentives for investment in new low carbon electricity generation, while recent planning reforms sought to remove non-financial barriers.
71. **The role of the regulator:** Ofgem regulates the gas and electricity monopoly networks as well as the competitive gas and electricity markets. Ofgem performs its role through a licensing regime, supported by wider powers in legislation. With some small exceptions, any company operating in the gas or electricity markets, whether supply, generation, networks or retail, must hold a licence from Ofgem. Through these licences, Ofgem sets out the conditions under which these companies can operate in the market. Ofgem monitors companies' compliance with these conditions, and can compel companies to supply information to support their investigations, as happened in the case of the Energy Supply Probe and Retail Market Review. If a breach of a condition is found, Ofgem can issue enforcement orders to secure compliance and/or may impose financial penalties of up to 10% of annual turnover.
72. In addition to its licensing powers, which are specific to the energy sector, Ofgem can call on powers that apply across all sectors of the economy. Ofgem is a competition authority under the Competition Act 1998 and, in the energy sector, it enforces competition law concurrently with the Office of Fair Trading (OFT). For example, in 2008 Ofgem decided to fine National Grid for acting in way that restricted the development of competition in the domestic gas

³⁸ Energy White Paper: Our energy future – creating a low carbon economy, DTI, 2003, <http://webarchive.nationalarchives.gov.uk/tna/+http://www.dti.gov.uk/files/file10719.pdf>

³⁹ Improving Grid Access. DECC, 2010.

http://www.decc.gov.uk/en/content/cms/consultations/mproving_gridi/mproving_gridi.aspx

meter market⁴⁰. Ofgem also has Enterprise Act 2002 powers to enforce cross-sectoral consumer protection legislation.

73. Separate from its regulatory duties, Ofgem has also become responsible for a number of delivery functions that are provided by its E-Serve arm and which are key to the success of a number of DECC policies. These functions were considered separately as part of the DECC Delivery Review. The Review concluded that Ofgem should continue to be responsible for both regulatory and delivery functions, although it was concluded that DECC and GEMA should take forward agreed improvements to the governance of Ofgem E-Serve and in programme and performance management and reporting⁴¹.

74. **The role of other bodies:** In considering the future role of the regulator it is also important to understand how its responsibilities and powers fit with those of other bodies that play a part in the market. Other than Consumer Focus, which is a non-departmental public body, all the bodies below operate independently of Government,

- Office of Fair Trading. The OFT is responsible for the enforcement of cross-sectoral competition and consumer law, and for merger control. The OFT's cross-sectoral powers are held concurrently by Ofgem and so, in practice, it is Ofgem that determines when to apply these powers in the energy sector. Consumer Direct is funded by OFT and provides advice to energy and other consumers.
- Competition Commission. The CC is responsible for conducting market investigations in areas referred to it by either the OFT or sectoral regulators such as Ofgem; merger cases referred by the OFT; and hearing appeals on certain types of decisions made by the regulators.
- Competition Appeals Tribunal. The CAT is a specialist judicial body whose function is to hear appeals, and review decisions, on competition issues. For example, National Grid appealed to the CAT against the fine imposed by Ofgem for restricting competition in the domestic gas meter market.
- Consumer Focus. Consumer Focus acts as the consumer advocate across many sectors, including energy. It has powers of investigation and can refer complaints to Ofgem where its enforcement functions are exercisable. Consumer Focus also provides dedicated advice for vulnerable consumers.
- Energy Ombudsman: The Ombudsman is responsible for operating a statutory redress scheme for consumers, and handles complaints from individual consumers about energy companies.

75. BIS are reviewing the institutional landscape for competition and consumer protection, and has proposed merging the competition functions of the Office of Fair Trading and the Competition Commission to create a single Competition and Markets Authority (CMA), and that Citizens Advice take on the functions of Consumer Focus', including those for the energy sector. As a result, this Review did not consider separately the roles of these institutions.

⁴⁰ Ofgem, 2009: <http://www.ofgem.gov.uk/Media/PressRel/Documents1/R20nationalgridmetering.pdf>

⁴¹ Delivery Review. DECC. May 2011. <http://www.decc.gov.uk/en/content/cms/about/partners/review/review.aspx>

Discussion: the cause of the role clarity issue

76. To address the issues described in the ‘scope and process’ section above the Review sought to understand their underlying reasons. At a high level, the principal cause could be described as the inability of the existing regulatory framework to evolve naturally in line with wider policy priorities, such as those related to climate change and security of energy supply. Given such priorities would continue to affect the energy market, steps would need to be taken if similar tensions were to be avoided in future.
77. Previous attempts to improve the alignment of the regulatory framework with Government strategy have included amendments to the duties (see the differences between Box 3 and Box 4) and the introduction of the Social and Environmental Guidance through the Utilities Act 2000. However, these have not succeeded in consistently and transparently achieving the desired coherence between the overarching strategy and the regulatory regime.
78. This disconnect can be attributed to two characteristics of the existing legal framework: the broad scope of the duties and the weak legal status of the Guidance. The duties describe the statutory boundary within which the regulator must make its decisions and are intentionally broad to allow the regulator flexibility and, therefore, space to ensure long-term stability. However, because of their broad nature, the regulator is given considerable room for interpretation, which could result in poor alignment between the regulator and Government’s views.
79. The Guidance has been a useful tool for clarifying some issues. For example, that it is for Government to make decisions that have significant redistributive implications, such as provision of financial support for the fuel poor; and 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. However, the effectiveness of the Guidance has been limited by a number of factors: its weak legal status in comparison to Ofgem’s other 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.
80. The combination of broad duties and weak guidance has resulted in a lack of confidence that the regulatory framework will be aligned with Government’s goals. In response, Government has made *ad hoc* interventions in the regulatory framework through primary legislation and PSOs. There is a need for an enduring solution that sees Government clearly taking responsibility for setting strategic direction, providing greater certainty for market participants, communicating strategy more effectively, and so avoiding *ad hoc* interventions where possible.

Options and conclusions

81. The Ofgem Review considered whether amendments to the principal objective and/or duties could help to resolve issues around role clarity. The core question considered was how far Ofgem’s statutory duties should embed wider public interest goals (such as those related to social, environmental, security and safety issues) alongside its core economic goals. This is important because, where issues are embedded in Ofgem’s duties, it is for them to make the sometimes difficult trade-offs between competing goals. In terms of role clarity, we need to ensure that it is clearly understood which issues Ofgem is responsible for considering and which are for Government, and that there will be coherence between Government and

Ofgem's decision making,

82. Today, Ofgem's duties embed a range of wider public interest issues. At one end of the spectrum of options for change, Ofgem's duties could be stripped back to focus on economic regulation. Ofgem would then take its own view on how to fit in with wider public interest issues – determined by Government itself or another regulator. At the other end of the spectrum, Ofgem's duties could be broadened to explicitly account for the interests of all citizens, rather than just gas and electricity consumers, implying broader public policy responsibilities for the regulator.
83. The Review concluded that wider public interest goals should remain embedded in Ofgem's duties: it is right that Ofgem should consider trade-offs between economic and broader goals in all its decision making. However, Ofgem's responsibilities should not be broadened: it is Government that should make trade-offs at the strategic level where the general interests of citizens are at stake. Ofgem's actions should be coherent with the direction set by Government, recognising that there will still be trade-offs that Ofgem will need to make at the level of regulatory decision-making.
84. There was also consideration of whether a clearer hierarchy of priorities should be embedded in the duties. However, the Review found that this would not be appropriate as the priorities are likely to vary by the type of decision being considered. It was therefore concluded that the duties are currently anticipated to remain essentially unchanged, recognising the benefits that this stability could provide for investors.
85. With the duties remaining essentially unchanged, it was necessary to consider other ways for Government to better communicate its strategic vision and associated high-level policy decisions to the regulator. Three main options were reviewed against the BIS Principles for Economic Regulation and presented in detail in the impact assessment published alongside the Ofgem Review Conclusions. Box 5 provides a summary of the two options that were rejected, while the next section describes preferred option: the introduction of a 'Strategy and Policy Statement'.

Box 5: Options considered, and rejected, by the Ofgem Review for delivering greater strategic direction to the regulator.

Do nothing: Government's wider policy goals would continue to be communicated through the Guidance.

There might be scope to make the Guidance more effective both by reviewing its content and by seeking to raise its profile. Should this prove ineffective, the use of primary legislation and/or PSOs would remain available to Government.

This option was rejected as it would only ever deliver limited improvements to the existing arrangements, with the risk of *ad hoc* interventions from Government remaining high.

Establish a new *ad hoc* 'Power to Direct': Government would take a power to define, on an *ad hoc* basis, individual strategic outcomes that the regulator must work towards.

In assessing the existing energy regulatory framework and roles within it, the Ofgem Review explored the arrangements for different economic regulators both at home and abroad,

Box 5: Options considered, and rejected, by the Ofgem Review for delivering greater strategic direction to the regulator.

including in Europe, Australia and the United States. One arrangement of particular interest was the ability of Governments to, in specific scenarios and under specific constraints, direct regulators to take particular actions or work towards particular outcomes. Such a mechanism for the energy sector could replace or supplement the existing Guidance, and provide strategic direction on key issues as considered necessary by Government.

This option was rejected primarily because of the following risks: that uncertainty over how often, as well as how, the power would be used would damage UK investment; and that the focus on individual issues on an ad hoc basis could lead to a piecemeal approach and unintentionally skew the focus of the regulator.

86. **The Strategy and Policy Statement:** the Strategy and Policy Statement provides 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, and ensuring that there will be coherence between this framework and the regulator's actions. It will also provide a transparent, enduring and holistic process through which the Government and Ofgem can consider progress and barriers to meeting strategic policy goals. Drawing from the broad policy landscape, it will allow Government to provide the strategic context within which Ofgem should interpret its duties. The Statement will be underpinned by new primary legislation and will include:

- **Energy policy and strategy:** a clear description of the Government's strategic goals for the gas and electricity markets, reflecting established policy.
- **Roles and responsibilities:** a description of the roles of Government, the regulator, business and other organisations in the energy market, with a focus on how Government's energy strategy would be delivered.
- **Policy outcomes:** clearly defined policy outcomes that Ofgem has a particularly important role in delivering, and against which Ofgem will be required to justify its independent regulatory decisions. 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. The type of outcome would vary depending on the specific policy context. For example, an outcome might express a broad policy goal, identify specific issues or barriers, or define quantitative deliverables.

87. The Strategy and Policy Statement will be prepared by Government and, to further facilitate transparency and accountability, the regulator will then be required to publish the following:

- **Forward plans:** 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. It may be appropriate to incorporate this into Ofgem's annual corporate strategy on which they are already required to consult.

- **Progress report:** 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. It is currently expected that this would sit in a dedicated report.

88. The Strategy and Policy Statement will be intended to remain stable over at least the length of a Parliament. However, 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 Statement should there be a significant change in policy. Given that the intention of the Statement is to increase regulatory certainty, it will be necessary to place clear parameters for the circumstances under which it can be revised:

- **EU requirements:** the Statement must always be compatible with the requirements of the EU third package, and any future EU legislation.
- **Consultation requirements:** to both to avoid unnecessary change and ensure that the Statement would, as drafted, be reasonably expected to achieve the desired results, Government would consult Ofgem and other interested parties on the proposed content. These consultation requirements would be specified in primary legislation. The Devolved Administrations, energy companies, consumer representatives and investors are some of the groups that are likely to have a strong interest in the Statement.
- **The role of Parliament:** to reflect Parliament's responsibilities in holding the regulator to account, the establishment of the Statement, as well as any subsequent revisions, would be subject to parliamentary approval, for example through affirmative resolution procedure. This would require Parliament to debate and approve the Statement before it could come into force.
- **When to review the Statement:** to provide certainty to the energy market the intention is that a Statement should remain stable for at least the length of a Parliament. However, the legislation would also need to accommodate the possibility that the Statement might need to be revised as a result of a significant change in policy. For example, if it were considered that the resulting differences between the Statement and policy could create unhelpful uncertainty for the market. Any change, carried out to ensure continued coherence between Government strategy and the regulated sector, would be subject to the consultation and Parliamentary requirements identified above.

89. Within the legal framework, it will be important to make clear the relationship between the Statement and the regulator's duties. While the Statement would set the strategic framework, the duties would continue to provide the functional context for day-to-day regulatory decisions. Therefore, although greater alignment with Government strategy might be expected to narrow the parameters within which Ofgem makes its regulatory decisions, the factors that Ofgem must consider, as described by their current statutory duties, are currently anticipated to remain unchanged. It will still be right, and necessary, for Ofgem to continue to consider trade-offs between economic and broader goals albeit within the context set by the Statement.

90. In implementing the Statement the existing Guidance would be repealed, but Government would still be able to use primary legislation to amend the regulator's existing duties and/or

make specific interventions. However, the existence of the Statement, and the transparent process by which it could be amended, is expected to make such legislation much less likely.

91. As described in the impact assessment that accompanies the Ofgem Review conclusions document, the Statement delivers clear benefits when considered against the BIS Principles for Economic Regulation (see Box 1). It is adaptable if required but, in addition, it provides a more complete and transparent approach to ensuring that there will be coherence between Government's strategy for the regulated energy sector and regulatory decisions. This transparency, welcomed during informal discussions with stakeholders prior to the publication of the conclusions, would also provide a more predictable policy environment for companies and investors.
92. The Government's intends to introduce the legislation giving effect to this policy, and consequently the Statement, as soon as Parliamentary time allows. The final form of the Statement and legislation associated with it will be developed during the course of the drafting of the primary legislation necessary to give effect to the policy.

Governance

Background

93. Good corporate governance is fundamental to any effective organisation and is the hallmark of any well-managed corporate entity. 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. Given the central importance of effective corporate governance, the Review went back to first principles in exploring options for optimising Ofgem's corporate governance structures.
94. GEMA was established in the Utilities Act 2000. Similar to any corporate board, its broad role is to provide strategic leadership and direction for the organisation. In its own words, GEMA "determines strategy, sets policy priorities and takes decisions on a range of matters, including price controls and enforcement". GEMA's work is carried out primarily in monthly board meetings, and through the work of Committees, which are set up by the Authority and chaired by non-executive directors.
95. GEMA's membership is defined in Schedule 1 of the Utilities Act 2000, which dictates that GEMA's members should be appointed by the Secretary of State and comprise a Chair and no fewer than two other members. In practice, GEMA has always been larger than this minimum to ensure the board is sufficiently resourced to meet its commitments and responsibilities, and in order to provide the range of expertise and skills that GEMA's duties require. While Government is responsible for the appointment of all GEMA members, it has no involvement either in GEMA's regulatory or operational decisions, including the operation of corporate governance systems.
96. Since the appointment of the current Chair Lord Mogg in 2003, the board has typically comprised some eight non-executive and four executive members (see box 6 below). The non-executives are appointed by the Secretary of State following open competition, and are expected to contribute 45 days a year, or 3-4 days a month to the role. Executives are appointed to their roles in Ofgem by GEMA; it is then for the Secretary of State to decide

whether they should be appointed as members of GEMA.

Context for appointing members to GEMA

97. There is a range of guidance and legal requirements that provides the context for considering approaches to corporate governance.
98. For GEMA, the legal framework is set by the Utilities Act 2000 and the EU Third package. Key constraints from the Utilities Act are the requirement that GEMA comprise at least the Chair and two other members; and from the EU Third Package that members must be appointed for terms of 5-7 years, renewable once; with members only able to be removed before the end of their term under very limited circumstances.
99. All external appointments, and reappointments, to public bodies must be made in line with the Code of Practice set by the Office of the Commissioner for Public Appointments (OCPA). The OCPA Code is designed to ensure selection by merit, and so provides a clear and transparent process for public appointments. It also includes mandatory requirements for the term of appointments, such as that the total period in office for each member of a public body must not exceed 10 years.
100. HM Treasury's "Corporate Governance in Central Government Departments: Code of Good Practice"⁴² provides guidance for central Ministerial government departments. Key characteristics of good corporate governance highlighted by the Code include accountability; board effectiveness and capability; non-executive independence; and clearly established systems for internal control and risk management.
101. As a Non-Ministerial Department, not all this guidance is applicable to Ofgem. However, the HMT Code states that the guidance will be useful for other parts of government and should be applied with adjustments to suit scale, responsibilities and accountability chains.
102. The 'UK Corporate Governance Code'⁴³ produced by the Financial Reporting Council sets out standards of good practice for corporate governance in the UK aimed primarily at the private sector. This has provided useful context when considering governance, and allowed a comparison to best practice outside of Government.

⁴² Corporate Governance in Central Government Departments: Code of Good Practice. HMT. 2005. http://www.hm-treasury.gov.uk/psr_governance_corporate.htm.

⁴³ UK Corporate Governance Code. FRC. 2010. <http://www.frc.org.uk/corporate/ukcgcode.cfm>

Box 6: Current membership of the Gas and Electricity Markets Authority (GEMA)⁴⁴

Non-Executive	Career Highlights and Experience	Date Appointed
Lord Mogg KCMG (Chair)	Former EU Commission Director General; a career in the British Civil Service including Deputy Head of the European Secretariat in the Cabinet Office.	2003
Miriam Greenwood OBE DL	A Barrister with qualifications in corporate finance; a career in financial institutions and banks including Director of Corporate Finance.	2004
Jayne Scott	Accounting career including Finance Director and advisory work on electricity privatisation; established a new Management Consultancy.	2004
John Wybrew OBE	Former Executive Director at successor companies to British Gas; a board member of Shell UK; Chair of the Sector Skills Council.	2004
Professor David Fisk CB	A Chair in Systems Engineering at Imperial College. Previously Chief Scientist at the Department of Environment, Transport and the Regions and the Office of the Deputy Prime Minister.	2009
David Harker CBE	Non-executive Director of the Advertising Standards Authority. Former Chief Executive of Citizens Advice and Director of the charity Sense.	2009
John Howard	Qualified solicitor, a career in broadcasting, former Chair of the Financial Service Consumer Panel.	2009
Jim Keohane	A career in the energy industry including Director at Eastern Group. Previously Non-executive Director and Deputy Chair at the Civil Aviation Authority.	2009

Executive	Role	Date Appointed to GEMA
Alistair Buchanan	CEO	2003
Sarah Harrison	Senior Partner, Sustainable development	2005
Andrew Wright	Senior Partner, Markets	2008
Stuart Cook	Senior Partner, Smarter grids and governance	2010

⁴⁴ Further information of GEMA members is available at <http://www.ofgem.gov.uk/About%20us/Authority/Pages/TheAuthority.aspx>

Operation of corporate governance systems

103. Whilst Government has no involvement in the operation of corporate governance systems within Ofgem, Ofgem do conduct an annual review of GEMA performance the outcome of which is submitted to DECC. Additionally, a triennial review is carried out by an external organisation, that evaluates GEMA against the HMT Code. The most recent audit concluded that Ofgem has sound structures and processes in place to support the governance of the organisation and has demonstrated compliance with the Code.

Governance models

104. The composition of GEMA reflects that commonly adopted for boards in the UK, including by other economic regulators (see box 7): 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).

105. The common feature across the unitary and two tier models is the presence of non-executive board members. The role of the non-executive is to support, monitor and challenge the executive; advising on strategy development, performance, operational and management issues. Non-executive members benefit the board as they bring external expertise and experience, and importantly are able to provide a more objective view to the board as they do not report to the CEO and are not involved in the day to day running of the organisation.

106. The two-tier governance model separates legal responsibility between a supervisory board of non-executives, supported by a second tier executive management board. This model is common amongst regulators in other countries, notably in Europe and the US. Some public bodies in the UK – such as Consumer Focus, the Health and Safety Executive and the Arts Council use a model similar to this. Executives will usually be present at board meetings but decisions are the responsibility of the non-executive members alone.

107. The primary strength of a two-tier model is considered to be that the separation of control and management between the two boards allows each to operate more effectively. The executive can focus on management issues, and as non-executives meet separately, in theory they are free to provide challenge more openly than in a unitary board, and take decisions more dispassionately.

108. The Higgs Review⁴⁵ (2003) explored board structures in the UK and reported that the majority view was that the unitary model brings considerable benefits, concluding that it should continue to be the model commonly adopted in the UK. The benefits highlighted were:

- The value of executive knowledge within the board, alongside non-executive directors who can bring wider experience.
- In the UK, the general legal duties owed to the company by executive and non-executive directors are the same.

⁴⁵ Higgs Review. 2003. <http://webarchive.nationalarchives.gov.uk/http://www.dti.gov.uk/bbf/corp-governance/higgs-tyson/page23342.html>

- All directors are required to act in the best interests of the company.
- Each has a role in ensuring the probity of the business and contributing to sustainable wealth creation by the company as a whole.

109. In addition to these benefits, the unitary model is considered particularly appropriate where the shareholder(s) are able to provide clear strategic direction for the organisation, with a unified board capable of making and implementing decisions more efficiently than under a two tier structure.

110. Higgs emphasised that the role of the Chair is central to realising the potential of the unitary board. It is the Chair's responsibility that board meetings are able to take full account of the views of all board members, and that meetings are focused on forward looking and strategic issues, rather than considering matters that could be decided by management.

111. To optimise the effectiveness of the unitary board model, an important consideration is the balance of executive to non-executive members, in order that the non-executive can provide a meaningful challenge function. For most UK economic regulators, this has meant having not only a non-executive chair but also a clear majority of non-executive board members. Some boards go further and appoint the CEO as the only executive member of the board, such as in the case of the Environment Agency.

Providing strategic direction

112. As mentioned, the unitary model is considered particularly appropriate where it is the shareholder(s) that establish the goals of an organisation. For Ofgem, these goals are currently intended to be established through GEMA's statutory duties and the Social and Environmental Guidance, which are discussed in the background to the roles clarity section above.

Discussion and conclusions

The structure of GEMA

113. The Review found that the existing unitary model was best suited for Ofgem's purposes. No particular concerns were raised with the Review about the current unitary model that has been adopted for GEMA, either by members of GEMA itself or by stakeholders. Whilst the various governance models each bring their own strengths, a unified board is the most efficient for decision-making and implementation, providing that Government gives clear strategic direction to GEMA.

114. The Review therefore considered whether there were any actions that could enable corporate governance to operate more effectively within the existing model: a board comprising both executive and non-executive members, with a non-executive chair, and a majority of non-executive members.

Board membership

115. The non-executive membership of GEMA needs to have a balance of policy expertise and experience relevant to GEMA's duties, as well as skills relevant to the board's leadership of the organisation. The Review considers that the broad range of expertise that should ideally be represented among the GEMA non-executives are:

- economic regulation;
- corporate finance;
- social and consumer issues;
- the energy industry; and
- environment/sustainable development.

116. Outside of this core expertise, there are additional areas of knowledge that it would be desirable for the board to have amongst its non-executives, but which might not be defining characteristics for any individual recruitment. These include knowledge of the Scottish and Welsh energy sector, experience of working with the public sector, and operational delivery, given the board's oversight of Ofgem E-Serve.

117. In terms of balance of expertise, since 2003 most of these areas have been represented by at least one board member, and typically represented by two. The notable exceptions include 2004-8 when there was no non-executive member with a background in social and consumer issues, nor since 2008 has there been a member with a background primarily in economic regulation. The board would be strengthened further with the recruitment of a non-executive with specific economic regulation expertise during the next round of appointments.

118. The executive membership of GEMA includes the CEO and several senior officials. Best practice, as described in HM Treasury's "Corporate Governance in Central Government Departments: Code of Good Practice" states that the board should also include a professional finance director, whose responsibilities should include advising the CEO and all members of the board in the financial management of the organisation's operations. GEMA would be brought more fully in line with best practice with the inclusion of the finance director.

119. Looking forward, the term of the current Chair will end in 2013 and at that time a new appointment will need to be made. The appointment must be made in line with OCPA Code of Practice and the requirements of the 3rd Energy Package.

Strategic direction

120. The shortcomings of GEMA's statutory duties and the Social and Environmental Guidance in providing strategic direction to GEMA have been discussed in the 'role clarity' section above. To support GEMA in providing effective corporate governance, DECC needs to apply itself more to its role in providing strategic direction – and this will be delivered through the Strategy and Policy Statement, also described above. In producing the Statement, the Government will have to communicate more clearly the goals that Ofgem should contribute to, providing a new focus for Government and GEMA to consider the challenges ahead for the energy sector.

Operation of corporate governance systems

121. Overall the Review found that GEMA has good corporate governance systems in place. In the Call for Evidence stakeholders did raise concerns around the transparency of Ofgem's processes. These concerns were shared with Ofgem, and their response can be found at Annex A.

Box 7: Governance structures of UK economic regulators

	Ofgem	Ofwat	Ofcom	ORR	CAA
What size is the Board?	Non-executive Chair, 4 executive directors, 7 non-executive directors.	Non-executive Chair, 3 executive directors, 5 non-executive directors.	Non-executive Chair, 3 executive directors, 5 non-executive directors.	Non-executive Chair, 4 executive directors (expected to rise to 5 from Aug 2011), 4 non-executive directors.	Non-executive Chair, 6 executive directors, 6 non-executive directors.
What is the skill set of the Non-Executive Directors?	<p>Individuals do not represent a particular policy area.</p> <p>The experience of the non-executive typically includes:</p> <p>Corporate finance; economic regulation; consumer issues; the energy industry; environment/sustainable development.</p>	<p>Individuals do not represent a particular policy area.</p> <p>The experience of the non-executives typically includes:</p> <p>City/investors, consumers, non-executive, regulation, water industry and Whitehall.</p>	<p>No special areas of responsibility, although the non-executives have been chosen to provide a mix of skills and expertise across the communications sector.</p>	<p>Individuals do not represent a particular policy area.</p> <p>The experience of the non-executive includes:</p> <p>economic regulation; corporate finance; engineering, manufacturing, supply chain; business development/capital programme management; consumer interests; the rail industry.</p>	<p>The non-executive directors bring the following experience:</p> <p>Transport & tourism, aviation safety, corporate finance, consumer interests, economic regulation, and working in Government.</p>
How many days are the Non-Executive Directors contracted for?	<p>The Chair is contracted to work 3.5 days a week.</p> <p>Non-executives are contracted to work 45 days a year (3-4 days a month).</p>	<p>The Chair is contracted to work 3 days a week.</p> <p>Non-executives work 2 days a month. (This may increase following recommendations from the Ofwat Review).</p>	<p>The Chair is contracted to work 3 days a week. Current Deputy Chairman is contracted for 3 days a week.</p> <p>Remaining non-executive members work two days a week.</p>	<p>The Chair is contracted to work 3 days a week.</p> <p>Non-executive directors work an average of 3 days per month.</p>	<p>The Chair is contracted to work 2 days a week.</p> <p>Non-executive directors are contracted to work 1 day a week.</p>

Accountability

Background

122. Accountability is key to establishing the legitimacy of decision makers in all organisations and structures. It depends on a number of factors, including transparency, a requirement to explain decision making, exposure to scrutiny and the ability to challenge. The BIS Principles for Economic Regulation noted that for 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; and
- 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.

123. Best practice for accountability and transparency of public bodies has been described by Cabinet Office⁴⁶ and the Independent Commission on Good Governance in Public Services⁴⁷. Their reports outlined a number of principles that included:

- **Transparent decisions:** there should be clarity over how decisions are made in an organisation so that these decisions are clearly understood by staff and stakeholders and can be more effectively implemented as a result. The impact of transparent decisions can also be assessed more easily, allowing a clearer context and understanding when making future decisions.
- **Reporting of performance and accounts:** public bodies should make easily available information on their role and purpose, so that those outside their organisation have a clear view as to its achievements and expenditure.
- **Open meetings:** a good way of engaging with stakeholders and strengthening transparency. Meetings should be held at least annually to allow stakeholders to improve their understanding of the organisation.
- **Stakeholder engagement:** stakeholder consultations should be carried out wherever relevant to ensure that the work being done is responsive to needs. Consultations should be proportionate to the size and resources of the body concerned.
- **Publications:** these should be accessible to the public, with exceptions based on confidentiality and security. Summary report of meetings, excluding confidential

⁴⁶ Public Bodies: A Guide for Departments, Chapter 8: Policy – Openness and Accountability, Cabinet Office: http://www.civilservice.gov.uk/Assets/8_policy_openness_tcm6-2487.pdf

⁴⁷ The Good Governance Standard for Public Services, The Independent Commission on Good Governance in Public Services: <http://www.lfhe.ac.uk/governance/govpublications/goodgov.pdf>

maters, should be made available and written in an accessible language.

124. Greater confidence in the accountability of the regulator could increase regulatory certainty and translate into reduced risk for investors. Looking forward, this has to be an important consideration for the energy market given the funding that will be required to achieve our low carbon, renewables and security of supply objectives.
125. Areas in which Ofgem should be held to account include financial probity, value for money of its operations and the effectiveness of its regulatory decisions against its objectives and duties. As described above, the regulator must work within its statutory framework and, therefore, it should also be measured against it.
126. To facilitate this accountability there are transparency requirements on Ofgem. These are partly underpinned by section 5 of the Utilities Act 2000, which states that the regulator must both publish a forward work programme and an annual report on its activities. Ofgem goes beyond these minimum requirements. For example, recognising that their activities are of interest to the Scottish and Welsh Devolved Administrations, Ofgem provides evidence to scrutiny committees of the Scottish Parliament and Welsh Assembly. Ofgem also, for example, consults extensively, publishes the minutes of each GEMA Board meeting and conducts open sessions and educational seminars to stimulate stakeholder involvement.
127. Ofgem is directly accountable to the UK Parliament. Ofgem's budget is approved directly by Parliament without, as specified by the EU Third Package, the involvement of Government. Consequently, the annual process for setting the budget is tied to the regulator's consultation on its annual corporate plan, usually around the beginning of the year. This provides an opportunity for stakeholders, including DECC and HMT, to raise any concerns with the proposed programme of work and costs. Following the consultation, the regulator then sets out its main estimates for Parliament, which then votes on whether to approve the budget.
128. Parliamentary scrutiny of Ofgem's activities is, in the main, carried out by the Select Committees, which have the right to investigate Ofgem's activities as well as require it to give an account of itself through hearings and written evidence. The Departmental Select Committees (for example, the Energy and Climate Change Committee) consider the merits of the regulator's policies, whereas the Public Accounts Committee is entrusted with ensuring that Ofgem provides value for money.
129. The National Audit Office (NAO) supports Parliament in its role of holding Ofgem to account. The NAO audits Ofgem's finances each year and verifies that the regulator's financial statements are free from material misstatement, and also ensures that the recorded expenditure and income have been applied to the purposes intended by Parliament. The NAO may also report more widely on Ofgem's activities. For example, the NAO recently undertook a review of Ofgem's performance. This included consideration of how the regulator assessed itself against its own objectives⁴⁸. Compared to best practice, the report highlighted those ways in which the regulator was looking to strengthen its processes for setting outcomes and measuring its effectiveness against them.
130. The regulator can also be held accountable through the Courts by any interested party.

⁴⁸ Performance of Ofgem, NAO, October 2010:

http://www.nao.org.uk/publications/1011/performance_of_ofgem.aspx

The Judicial Review process, carried out in the High Courts, would potentially allow an individual, company or other organisation to challenge Ofgem's decisions. For example, where they consider the regulator has overstepped its statutory powers, made a decision using an unfair procedure, or made an unreasonable decision.

131. There are also ways for energy market participants to appeal decisions through the sectoral regulatory arrangements. Ofgem regulates the market through licences and industry codes. There is a right of appeal to the Competition Commission in relation to Ofgem's decisions on code modifications. And as part of the implementation of the EU Third Package, there will be a new right of appeal to the Competition Commission in relation to licence modification decisions.

Discussion: the problem

132. Despite the measures taken by the regulator to be transparent, the Call for Evidence responses identified a widespread perception that Ofgem could improve transparency. In general, it was felt that the regulator needed to better explain its strategy as well as its decisions, and that this explanation should be subject to increased scrutiny and challenge.

133. Although Ofgem has looked to implement the accountability principles described in the background above, there are examples of where initiatives have not always been fully effective. For example, the existing consultation process where stakeholders have often felt overloaded (see the following 'ways of working' section for more detail). It has, however, been the issue around role clarity which has been the main reason for the observed lack of scrutiny. If there were a better understanding of who was responsible for what, and greater clarity over intended actual outcomes, greater accountability would follow.

134. Several stakeholders raised questions over the value for money that Ofgem provides, and the routes through which their proposed budgets are scrutinised. Some believed that this was Government's responsibility. It is Parliament that is directly responsible for oversight of Ofgem's budget. This is to protect Ofgem's operational independence from changes in the political landscape and so provide greater regulatory certainty, and is a principle that is now embedded through the EU Third Package. The Government fully supports Parliament's role in scrutinising the value for money provided by Ofgem and will be interested to see how Ofgem develops its performance measurement and reporting, including a stronger focus on outcomes, as highlighted by the NAO.

Conclusions

135. The accountability arrangements associated with the Strategy and Policy Statement (described above) are an integral part of the policy and are designed to deliver greater transparency, and so support accountability. The Statement itself will require Government to be clear about its own goals, while the planning and reporting requirements on Ofgem will provide a clear line of sight between Government's strategic objectives and the actions taken to regulate the market. This material will assist all those who have a role in holding the regulator to account.

136. When considered against the BIS Principles description of what accountability should include the use of the Statement meets each of the three criteria. Government and Parliament would continue to set Ofgem's duties and energy policy, role and responsibilities would be more clearly defined, and the policy outcomes that the regulator must contribute to

would provide a transparent mechanism for holding the regulator to account against its decisions.

137. In parallel with the Review, Ofgem has, itself been reflecting on how it can demonstrate greater transparency. Ofgem's conclusions are set out at Annex A.

Ways of working

138. The operational behaviours of DECC and Ofgem, both in how they work together and how they work independently, are key underlying factors for the areas addressed in each of the previous three sections. The Call for Evidence identified a number of issues, some to be tackled independently and some to be tackled jointly.
139. Some respondents focussed on the way that Ofgem conducts its consultations. For example, the regulator could potentially set a clearer timetable for itself when concluding consultations that had closed. It was also suggested that the current frequency of consultations could result in consultation fatigue. Ofgem had to strike the right balance between ensuring that its processes were inclusive whilst not overloading stakeholders with information. More informal, collaborative methods earlier on in the decision making process might reduce the need for a formal consultations. Views on operational issues such as this were shared with Ofgem for them to consider independently and their response is set out in Annex A of this report.
140. Respondents also identified that, further to improving role clarity as discussed above, there was a need for Government and Ofgem to work better together, avoiding some of the operational difficulties that had arisen in the past. Achieving this might mean having a better mutual understanding of how each other's organisation operated as well as learning from best practice examples. In response, DECC and Ofgem are currently looking at existing processes between teams as well as ways in which to improve general understanding of the roles of each organisation.

Next steps

141. Implementation of the Strategy and Policy Statement will require primary legislation and the timing of this will be dependent on the forthcoming parliamentary programme. The final form of the Statement and associated legislation will be developed during the drafting of that legislation. In parallel, DECC plans to start to develop the content of the first Strategy and Policy Statement. We would propose that once the new legislation has Royal Assent, DECC will issue a full consultation on the Statement prior to it coming into force.
142. DECC and Ofgem will continue to develop their working arrangements. As has been true during the whole Ofgem Review process, the underlying principle will be to improve the way that the organisations work together towards the common strategic goals of a fair, secure and low carbon future.

Annex A



'Ways of Working' - Ofgem's response to issues raised in the Ofgem Review

Promoting choice and value for all gas and electricity customers

Executive Summary

1. In its summary of conclusions on the Ofgem Review, the Department of Energy and Climate Change (DECC) noted that the Government 'remained committed to a framework of independent economic regulation for the energy sector and to Ofgem as the independent regulator'⁴⁹. DECC also noted that Ofgem continued to be critical to meeting the Government's energy and climate change objectives.
2. The responses to DECC's 'Call for Evidence' on the Ofgem Review showed strong support for the principle of regulatory independence, which was seen as vital to providing the stability and continuity required to attract the significant investments needed in the energy sector. Furthermore, where it had been given a clear remit, Ofgem was generally considered by respondents to have performed to a high standard.
3. We welcome the Government's endorsement of the principle of independent economic regulation. We also welcome the positive assessment of our performance by respondents to the Ofgem Review. This included recognition of the role we have played in successfully establishing competitive markets, in regulating energy networks and the positive influence we have had on the development of EU energy policy. We believe that, within the policy framework set by Government, independent regulation of the energy markets continues to be crucial to the delivery of secure and sustainable energy supplies at the lowest cost to consumers.
4. Also highlighted were a number of operational issues emerging from the review on Ofgem's ways of working. These included concerns around whether we provide sufficient transparency in our decision making and value for money, on how we consult, on whether we are striking the right balance on risk management and, more generally, on the theme of engagement with stakeholders. DECC noted that these issues were a matter for Ofgem to consider.
5. We have been considering how we can best respond to these issues. Our review and conclusions are set out below under six headings: transparency and value for money, how we consult, working with other regulators, perceptions of risk, engaging with consumers and the Gas and Electricity Markets Authority. Key points from each heading are summarised below.
 - We recognise the importance of demonstrating how Ofgem provides value for money. We have published a new transparency section on our website to give easier access to the range of data we publish on costs and spending.

⁴⁹ Ofgem Review: Summary of Conclusions, Department of Energy and Climate Change, URN: 11D/694, May 2011.
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- We are committed to publishing a revised consultation policy before the end of 2011. Our current thinking is to see how we might align our policy more closely with the Council of European Energy Regulators (CEER) guidelines on public consultations. We are also looking at how we can give stakeholders greater advance information on our consultation activity and greater opportunities to participate in the consultation process.
- Ofgem has a strong track record of working with other regulators both in Great Britain and in Europe. This includes playing a full part in the work of the Joint Regulators Group (JRG) and the Regulators Chief Operating Officer (COO) Group. In Europe, Ofgem plays a full role in CEER and in the Agency for the Cooperation of Energy Regulators (ACER). We also work closely with neighbouring energy regulators on the regulation of interconnectors for gas and electricity, including both the use of existing capacity and potential new investment.
- One of the more interesting themes emerging from the Ofgem Review is a perception that Ofgem is too risk averse. There are compelling reasons for caution in our approach. However, this caution needs to be seen in the wider context of our work. Over the last few years we have demonstrated our willingness to take on challenging work and to act decisively to protect the interests of existing and future energy consumers.
- We have undertaken a lot of work in recent years to improve our understanding of what really matters to consumers. These initiatives have facilitated a much greater sensitivity across the organisation to consumer issues and fed into our decision making. We are looking at how we can more successfully communicate this work and show how consumer input has shaped our decisions.
- The Ofgem Review identified concerns around the transparency of decisions taken by the Gas and Electricity Markets Authority (the Authority) and the role of non-executive members. Non-executive members play a very active part in the full range of Authority business, but we recognise that this contribution is less clearly visible outside of Ofgem. We are considering how we might increase understanding of the role of non-executive members and their contribution to the work of the Authority.

Transparency and value for money

6. In its 'Call for Evidence' on the Ofgem Review, DECC asked for views on the value for money that Ofgem provides⁵⁰. Respondents generally considered that Ofgem provided value for money but also that we could provide greater transparency on our costs and spending.
7. Ofgem recognises the importance of demonstrating that it provides value for money. A key aspect of our value for money strategy is the internal cost control regime (RPI-3%) we adopted in 2005, uniquely amongst the UK regulators at that time. The cost control regime places on Ofgem a requirement to realise efficiencies similar to that expected of the network companies we regulate. In the five years to 2010 we have delivered £11.9 million of savings. On the basis of our existing business plans, we expect to realise further savings of £12.5 million in the five years to 2015. We remain committed to following this disciplined approach to cost control until at least 2015.

⁵⁰ Ofgem Review: Call for Evidence, Department of Energy and Climate Change, URN 10D/742, July 2010

8. However, responses to the Ofgem Review also noted that Ofgem could usefully provide more transparency on costs and spending. We have, in response, published a new Transparency section on our corporate website⁵¹. To improve visibility of this new resource, we have included a link to it on each page on our website. The Transparency section provides interested parties with access to key documents and data on costs and spending, including: details on what we spend, our strategy for making sure that we provide value for money and the arrangements we have in place to support our strategy.
9. The Transparency section includes a link to our annual Corporate Strategy and Plan, which we publish annually both in draft for consultation, and in final form, and which provides comprehensive information on our work and budget plans over a five year period. A link is also provided to our Annual Report and Accounts, which include a section on value for money and to information on the role, membership and meetings of the Gas and Electricity Markets Authority.
10. We have also published a new Transparency Statement setting out the four essential principles that underpin our approach to providing value for money. These are:
 - **transparency** – providing clear, consistent, comparable and accessible information
 - **accountability** – so that decision makers and budget holders can be held to account
 - **simplicity** – so that it is easy to understand what is going on
 - **coherence** – so that our activities are clear and logical.
11. We have also published a ‘Value for Money’ strategy which describes how we make sure that value is sought and achieved from our use of public funds. This strategy is designed to create an effective value for money culture across the whole organisation. Our strategy requires that:
 - the Gas and Electricity Markets Authority is required to satisfy itself that value is sought and achieved from the use of public funds
 - the senior management team and directors are responsible for putting in place the arrangements to support the delivery of our value for money strategy in each part of the organisation and for maintaining awareness of these arrangements
 - responsibility for achieving value for money lies with all members of staff and not only those with specific resource or financial responsibilities.
12. Our Transparency section provides clear links to the following key information on our spending and how we seek and demonstrate value for money:
 - our internal and external audit arrangements
 - payments to suppliers over £25,000
 - senior staff expenses
 - our ‘Corporate Strategy and Plan’ and ‘Annual Report and Accounts’
 - our ‘value for money’ strategy

⁵¹ <http://www.ofgem.gov.uk/About%20us/transparency/Pages/transparency.aspx>

- our procurement policy.

13. On 30 June 2011 we published, for the first time, a combined Annual Report and Resource Accounts, bringing together information previously published as separate documents. We believe that the combined document, together with the other steps we have taken to comply with Government requirements on transparency, demonstrates our commitment to achieving value for money.

How we consult

14. A key theme emerging from the Ofgem Review is how we consult. The principal concerns expressed include that we issue too many consultations; that consultation and supporting documents are too long and too detailed; that the timescales we give for responding to consultations are too short; and that there are too many consultations live at the same time, putting particular pressures on smaller stakeholders. It was also suggested that Ofgem should, as a matter of practice, routinely provide a timeline for its response to a consultation so that stakeholders are clear on what will happen next and when.

15. Are these concerns valid? We issue approximately 100 consultations per year. We appreciate that, on the surface, this suggests a very significant amount of consultation activity. But the reality is that, in response to fast evolving markets, we are necessarily a busy organisation with a duty to protect the interests of consumers over many areas of what is a complex energy landscape. This requires regular consultation.

16. There are strong pressures on us to consult. Indeed, in many instances we have a statutory duty to do so. Even where we have reached agreement with the companies we regulate, we are often required to consult on changes to licence conditions in order to give effect to that agreement. Where we do not have a specific obligation to consult, the principles of transparency and accountability suggest strongly that we should. Consultation can be a very effective means of improving policy via the feedback from interested parties and helps to build understanding of our work. This enables decisions to be made by consent. Consultation also helps to make clear our decision making process and, carried out properly, mitigates legal process risks, which is in the interests of both the industry and energy consumers.

17. For these reasons, regular consultation will continue to form an important part of the regulatory process. The number of consultations will inevitably vary over time. But it is worth noting that, despite the emergence of Ofgem E-Serve, the number of consultations has remained broadly steady over recent years.

18. Even for those stakeholders who do not feel that we consult too frequently, there is a concern that we do not provide sufficient time for responses. A further concern is that, having set a timescale by which responses must be submitted, we do not then always commit to a clear timescale on when we will publish a summary of responses, issue a further document, or take a decision.

19. The most recent statement on Ofgem's consultation policy was published as part of our Guidance on Impact Assessments in December 2009⁵². In that guidance, we set out our commitment to a minimum consultation period of six weeks where possible and, where

⁵² Guidance on Impact Assessments, Ofgem, 151/09, December 2009

the period is shorter, to explain why. We also state that we may give more than six weeks if the policy is complex or likely to be controversial, if policy is at an early stage of development, or if a consultation takes place over a holiday period. Equally we note that there may be exceptions where consultation on a policy follows a timetable set down by the Gas Act, the Electricity Act or associated licence conditions or industry codes.

20. A review of our consultation activity in 2010 reveals that we have not managed to meet our stated policy. For example, a majority of consultations were for five weeks or less, although this did include a number of consultations where the timescale is set by statute. Only about one third of our consultations met our stated aim of six weeks. On a number of key issues we allowed ten weeks or more for consultation.
21. We recognise that our performance on consultation durations has fallen short of our stated policy. However, it is important to recognise that we often consult more than once during the course of reaching a decision and that we also take a multi-layered approach. This includes formal consultations being supplemented by other types of engagement, including seminars and workshops, all designed to help consultees engage in the consultation process.
22. We have compared our approach to that taken by other regulators to see what we might do to improve, whilst retaining the clear benefits of regular consultation. The key outcome is that we propose to publish a revised statement on Ofgem's consultation policy before the end of 2011, setting out the principles that will govern how we consult and taking full account of the comments made and the potential delays that we face as a result of changes to our policy.
23. Our revised consultation policy will take into account the guidelines on public consultation published by the Council of European Energy Regulators (CEER). It will explain clearly the basis on which we will decide the appropriate period for consultations, including the circumstances in which we will commit to consulting for longer than the eight week period that is likely to sit at the centre of our future approach. Our current thinking is that our revised policy will be based on three distinct consultation periods, each period recognising a different degree of urgency, impact and likely interest in a proposal. These periods being:
 - **four weeks** for matters that are urgent, or which follow on from earlier consultations, or which represent minor changes to existing policies, or where we are working to a timescale set by a third party
 - **eight weeks** for consultations that are unlikely to have a very wide impact or be the subject of substantial interest
 - **twelve weeks** for consultations on significant issues where it is expected that there will be wide interest.
24. Our revised consultation policy is also likely to include a requirement for consultation documents to set out:
 - the factors that have been considered in arriving at the timescale allowed for responses, including, where relevant, an explanation as to why the timescale is less than eight weeks
 - what will happen next and when, ie when we will publish responses to a consultation or announce a decision.

25. We will also consider whether the approach set out in our revised consultation policy should apply to requests for information from licensees, so that when requesting information we would set out what will happen next and when.
26. Respondents to the Ofgem Review also expressed concerns on the length of our consultation documents and supporting material. Typically, our consultation documents are approximately 40 pages, with around 20 pages of annexes. We appreciate that there are examples of lengthier documents relating to our most significant or far reaching projects. To some extent this is an inevitable feature of the transparency required for stakeholders to fully understand and agree major proposals.
27. We recognise that lengthy consultation documents can require a significant amount of work on the part of our stakeholders. In 2005 we embarked on our internal 'Project Paperless' exercise, which was designed to reduce the length of our documents and improve their readability. Typically, our consultation documents are now shorter than in prior years. This change, which continues as part of a new internal drive on excellence in written communication, reflects our recognition that our audience has evolved and is no longer so closely aligned, as it perhaps once was, with a core group of industry specialists.
28. In recent years we also made increasing use of open consultation letters, which tend to be significantly shorter than formal consultation documents. In 2010 the majority of our consultations were issued as open letters. We expect this trend to continue.
29. We feel that good progress has been made in this important area and that our documents are now more accessible, not only to the industry but to our wider audience, including small businesses, charities and environmental bodies. We appreciate that this wider readership has a range of interests, knowledge and resources that are different to the companies we regulate. To address these differences we are also examining how we can publish plain English summaries of key consultations that are of special interest to our wider readership.
30. We are also considering how we can make better use of the annual corporate planning process to provide stakeholders with greater forward detail on our planned consultation activity. We are also looking at a major review and upgrade of our corporate website. As part of this review, we will be examining how we can use the website and other electronic communication tools to provide stakeholders with more information on our consultation activity, including regular updates on the opening and closing dates for consultations and more opportunities to actively participate in the consultation process.
31. A number of respondents argued that Ofgem should consider greater use of Post-Implementation Assessments (PIAs) to measure the outcomes of the decisions it makes following on from consultation. As is set down in our 'Guidance on Impact Assessments', our approach is that Impact Assessments should set out clearly our intentions as to the appropriate form of post-implementation review stating, for example, whether we intend to conduct a major post implementation review or rely on routine monitoring⁵³. Where we decide that routine monitoring is appropriate, we will report on outcomes in our Annual Report. Where outcomes are not as expected, Ofgem will, if appropriate, flag its intention to conduct a major review.

⁵³ Guidance on Impact Assessments, Ofgem, 151/09, December 2009

32. To some extent this issue is about how we communicate our post-implementation assessment work – although not published as a formal PIA, all of our follow up work on our Energy Supply Probe could be seen in that light. However, we accept that this is an area where we need to explore and improve our communication.

Working with other regulators

33. A number of respondents stressed the need for and the benefits of greater cooperation between regulators. In common with other regulators, Ofgem understands the importance of the interplay between sectoral regulation and general competition policy. We are therefore conscious of the need to work in cooperation with other regulators, not least because many regulators have concurrent powers under the Competition Act 1998.

34. Ofgem plays a full part in the work of the Joint Regulators Group (JRG), which brings together the Heads of the various regulators, usually at Chief Executive level. The JRG meets four times a year to discuss issues of mutual interest and to report on recent developments in their own particular sector. The minutes of each meeting are published on the Ofgem corporate website and on the websites of the other regulators. The Chairs also meet on a regular basis.

35. In addition to the regular series of meetings, JRG members already collaborate on an ad hoc basis. Recent examples of this collaboration include technical approaches to cost-benefit analysis and pensions, and there is on-going collaboration through the concurrency working party. As part of a wider review JRG is considering how to improve scope for coordination and collaborative work.

36. Sectoral agendas, regulatory independence and existing obligations to collaborate, eg at EU level, place some practical limits on the scope for deeper collaboration between the regulators. However, there is a keenness to explore how enhanced collaboration between JRG members can allow greater sharing of intellectual and other resources on issues of common interest and facilitate improvement in the delivery of statutory duties. Work to assess scope for this is being proposed.

37. Ofgem is also a part of the Regulators Chief Operating Officer (COO) Group. COO brings together the operational heads of the various regulators to discuss issues of mutual concern and to exchange experiences and good practice in the support services (Finance, Human Resources, Information Management and Technology, Procurement and Building Services). The main focus in recent months has been in the area of greater collaboration between regulators, including shared services. Ofgem already provides various services to Postcomm, The Charity Commission, The Pensions Regulator and The Northern Ireland Utility Regulator, including the administration of the Northern Ireland Renewables Obligation.

38. In addition to our work with other regulators, Ofgem works actively in Europe to support the vision of a competitive, secure and sustainable European energy market that brings affordable and secure energy supplies to consumers. European energy markets and regulatory policy have an important influence on energy consumers and energy markets in Britain. We therefore welcome the general endorsement in the responses to the Ofgem Review of the value and effectiveness of our work in Europe.

39. Ofgem works closely with the European Commission, the new Agency for the Cooperation of Energy Regulators (ACER) and with fellow national energy regulators including through

the Council of European Energy Regulators (CEER). Lord Mogg, Ofgem's Chairman, is currently president of CEER and in April 2010 was elected as the Chair of the ACER Board of Regulators. He also chairs the International Confederation of Energy Regulators (ICER). Ofgem also provides the vice-chair of the electricity working group, the co-chair of the group developing the gas target model and chairs or leads various other regional or sectoral groups and workstreams⁵⁴. Ofgem also worked closely with the recently disbanded European Regulators Group for Electricity and Gas (ERGER).

40. ACER was established under the EU Third Internal Energy Package. Its role is to complement and coordinate the work of the National Regulatory Authorities (NRAs), to promote market integration through the Framework Guidelines and Network Codes established in the Third Package and to resolve disagreements between NRAs on access to cross-border infrastructure. Ofgem, through its role in ACER, is playing a leading role in the development of European Framework Guidelines for gas and electricity.
41. CEER is the voluntary body that brings together the national energy regulators for collaboration in sharing best practice and developing positions outside ACER's remit. Ofgem is actively involved in all of the CEER working groups established to take forward its activities. For example, Ofgem has for several years led CEER's work on sustainable development.
42. In addition, Ofgem works closely with neighbouring energy regulators on the regulation of interconnectors for gas and electricity, including both the use of existing capacity and potential new investment.

Perceptions of risk

43. One of the more interesting themes emerging from the Ofgem Review is a perception that Ofgem is too risk averse. This perception arises in two related contexts: Ofgem is seen as taking too long to reach decisions because of the need to be certain that our process and decisions are legally robust; and that we use the consultation process as a means of managing legal risks that could be handled just as effectively (and perhaps at lower cost) by other and earlier types of engagement with stakeholders.
44. We consider that there are compelling reasons for caution in our approach to the management of risk. Our principal duty is to protect the interests of gas and electricity consumers. In our capacity as an independent economic regulator – and in common with other regulators – we face a range of complex challenges, many of which carry significant consequences for energy consumers and the companies we regulate. The nature of our work is therefore not only complex but can also involve the need to undertake some types of work for the first time. As a result we can, and we do, face novel legal challenges for which there is no existing example of an 'off the peg' solution that we can use or adapt from earlier work, either by Ofgem or other regulators. These challenges especially require a high degree of precision in the development of policy and robustness of the legal review process.

⁵⁴ Examples include: chair of the France-UK-Ireland electricity regional initiative, chair of the European energy regulators' work on gas balancing, chair (to June 2011) of the regulators' group on the North Sea Countries Offshore Grid Initiative, lead of the North West Europe gas region's work on transparency and lead regulator on development of cross-border intraday trading in electricity.

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45. We believe that the interests of energy consumers and the companies we regulate are best served by an approach that strikes a cost effective balance between the potential impact of a decision and the resources required to achieve it. Decisions based on flawed reasoning or a lack of attention to due process can, at the very least, result in frustration and delay. Such decisions may, on occasion, also lead to legal challenges that lead to an increase in uncertainty and costs for the industry and for consumers. This can have a corrosive effect on existing and future confidence in the regulatory process. Getting the balance wrong on risk would undermine our ability to secure the regulatory settlements needed to protect the interests of energy consumers.
46. We recognise that our approach to managing the risks inherent in the legal process can and sometimes will impact on timescales and costs. But, as part of our work to respond to the issues raised in the Ofgem Review, meetings with other regulators have provided reassurance that our approach is not very different from those who face similar challenges.
47. However our concern for legal robustness needs to be seen in the wider context of our work, which demonstrates clearly that we are prepared to take difficult decisions and to act decisively. Over the last few years we have demonstrated our willingness to take on challenging work and to take difficult decisions to protect the interests of existing and future energy consumers.
48. Ofgem's Project Discovery recommended far reaching reforms of the energy market to deliver future security of supply at affordable prices. This important work, seen by some respondents to the Ofgem Review as blurring the boundary between the role of the regulator and the role of Government, was a necessary response to our duties in relation to security of supply and to future consumers. Our work on RIIO (Revenue = Incentives+Innovation+Output) reflected our willingness to develop a new and forward thinking framework to meet the challenges and opportunities of delivering the networks required for a sustainable, low carbon energy sector. Our work on the Energy Supply Probe and the Retail Market Review has shown that we are prepared to take on energy suppliers and to propose radical measures to improve the operation and transparency of the retail energy markets.

Engaging with consumers

49. An important theme emerging from the Ofgem Review is the extent to which consumers can hold Ofgem to account and influence our decisions. We have undertaken a lot of work in recent years to improve our understanding of what really matters to consumers. Important features of this work include our Consumer First programme, launched in 2007 and our Challenge Group of eight consumer experts who act as Ofgem's 'critical friend'. The Challenge Group brings into our considerations additional expertise that would be difficult to otherwise access.
50. The programme includes a Consumer First Panel, consisting of 100 energy consumers recruited from five locations across Great Britain. Panel members and the locations they are recruited from change annually. During that period panels meet regularly to discuss key energy issues, including issues impacting on their participation in the energy market. We have published research findings from the Consumer First Panels on a range of issues including price controls and smart meters. We have also undertaken and published other consumer research. Since 2009 we have published a series of Consumer Bulletins, giving

updated information on our work to protect the interests of energy consumers.

51. These initiatives have facilitated a much greater sensitivity across the organisation to consumer issues and fed into our decision making. However, the responses to the Ofgem Review indicate that some stakeholders are not fully aware of the progress that we have made in this area. We are therefore looking at how we can more successfully communicate this work and show how consumer input has shaped our decisions.
52. In addition to working with other regulators, Ofgem also works in partnership with other organisations where that can help to protect the interests of consumers. Since 2008 Ofgem has worked with Citizens Advice on developing and delivering face-to-face consumer advice through the 'Energy Best Deal' scheme. The scheme works by holding training sessions for both consumers and frontline advice workers to explain how domestic consumers can reduce their energy costs by changing their tariff or energy supplier. It also raises awareness of the help available from both suppliers and Government for those who are struggling to pay their energy bills.
53. Energy Best Deal has proven to be a real success in helping consumers. Working together with Citizens Advice we have recently extended the scheme's materials to include a series of seven short films covering the scheme's key messages. These are available to view on our website and include a film showing consumers discussing the savings they have made thanks to Energy Best Deal⁵⁵.
54. We are currently reviewing our corporate website. As part of this review we will also be looking at how we can provide an improved, more informative and more engaging experience for all of our users, but particularly for consumers and small businesses. The outcome we are looking for is to provide these users with improved ease of access to the resources and information they need to understand our role and to empower them to participate in the energy markets with greater confidence and effectiveness.
55. Our current thinking includes looking at how we might increase the number and type of opportunities for communication with Ofgem. Examples may include: increasing the use of video conferences, webinars, online forums and feedback tools that, where relevant, provide clear links to resources designed to support wider engagement, eg plain English summaries. We also look to bring together broader groups of stakeholders, for example we host the London Forum (also known as the Citizens' Energy Forum) which brings together representatives from across Europe to focus on implementation of competitive, energy efficient and fair retail markets for consumers. The clear objective of these developments is to enhance understanding of our role, with the result that we encourage, increase and widen industry and consumer participation in our work.

The Gas and Electricity Markets Authority

56. The Ofgem Review identified a number of concerns on what is perceived as a lack of transparency on how the Gas and Electricity Markets Authority (the Authority) reaches decisions and the role that non-executive members play in that process. There were two principal concerns: the minutes of Authority meetings do not give stakeholders clear understanding of how decisions are arrived at, or the ability to gauge to what extent non-executive members provide an effective counterbalance and challenge to Ofgem.

⁵⁵ <http://www.ofgem.gov.uk/consumers/smebd/pages/smebd.aspx>

57. The principal record of the business of the Authority is the minutes of its meetings. Since the coming into force of the Freedom of Information Act in 2005, all major regulatory bodies have published records of their meetings. Approaches to the content and length of minutes of board level meetings vary. Some bodies' minutes are redacted before issue (and explicitly say so). Some are relatively short and give no real picture of the issues at stake, stating that the Board noted a report, or was "updated on an issue" or that "The Board was updated on the results of the recent forecasting exercise".
58. The minutes of each meeting of the Authority are published on the Ofgem website shortly after they have been approved by the next monthly meeting of the Authority. We believe that the minutes are at least as full and informative as those of other economic regulators. They provide a fairly full record of the main issues at stake, agenda item by item, the considerations which the Authority had in mind when reaching its conclusions, and what exactly these were.
59. The minutes of Authority meetings do not contain a detailed blow by blow account of the discussion outlining the specific contribution of members, nor are the papers discussed at the meetings published alongside the minutes. This should not be surprising. Much of the information and analyses underpinning decisions taken by the Authority is market and price sensitive; much of the data is collected under licence requirements and protected as such under statute. Similar considerations apply to enforcement cases, to sensitive data on supply and demand and to a range of papers, themselves often highly classified, dealing with the development of regulatory policy. The need to protect both information sources and discussions on public policy development is recognised in the Freedom of Information Act 2000.
60. However, the reasoning and decision-taking leading to proposals is always fully set out in consultation documents, in announcements about 'minded to' decisions, in press releases, factsheets, briefing documents, 'open letters' and more. Where appropriate, the documents are supported by published investment appraisals, consultancy reports and other independent studies which have formed the basis of deliberations.
61. We do not, as has been suggested in the responses to DECC's 'Call for Evidence' on the Ofgem Review, see value in publishing draft Authority minutes. In the absence of the Authority's approval, draft minutes could not be seen as an accurate record of the meeting. Furthermore, depending on the timescale for the announcement of certain decisions, such as price sensitive matters, it may be necessary to redact from the draft minutes reference to the very matters that may be of most immediate interest. On the grounds of transparency, clarity and due process, decisions on such issues are best communicated in full and not in the form of draft minutes.
62. As previously noted, some responses to the Ofgem Review suggested that the way the Authority works does not allow stakeholders to judge the effectiveness of the role played by non-executive members in its business. We welcome the Government's support, in its Summary of Conclusions on the Ofgem Review, for the unitary structure of the Authority, and its recognition that this mirrors the approach adopted by most boards in the UK and the other economic regulators. Non-executive members bring to the Authority a wide range of experience and expertise and many of its non-executive members hold (or have recently held) senior positions in the private sector and on other public bodies such as Ombudsman Panels, the Financial Services Authority, the Civil Aviation Authority and the Citizens Advice Bureau.

63. In addition to playing a full part in the monthly and occasional special meetings of the Authority, non-executive members take a highly active part in many Committees of the Authority bringing them into regular contact with Ofgem staff. This is not only appreciated by Ofgem colleagues at all levels, but seen as invaluable. Indeed, there are many examples of where constructive and effective challenge from non-executive members has led to different conclusions, nuanced decisions, or requests for new analyses to be carried out.
64. However, whilst the significant contribution of non-executive members to the work of the Authority is well known and highly valued within Ofgem, we recognise that this is less clearly visible outside of Ofgem. We are therefore considering how we might increase the visibility and understanding of the role of the non-executive members and their contribution to the work of the Authority. We are also reviewing the information available on the Authority on the Ofgem corporate website, to ensure that it gives a full and clear indication of its role, working practices and the experience and expertise of its membership.

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