

ENERGY BILL PROVISIONS FOR OFGEM STRATEGY AND POLICY STATEMENT

Background note

November 2012

Energy Bill provisions for Ofgem

The Second Session Energy Bill introduces a power for the Secretary of State to designate a new document, a Strategy and Policy Statement (SPS), subject to certain conditions. It introduces a transparent process to improve alignment between the Government's strategic energy objectives and regulation of electricity and gas markets by the independent regulator, Ofgem, while respecting Ofgem's independence in making regulatory decisions. This note is intended to provide background to inform debate during the passage of the Bill through Parliament and for industry, consumer, environmental and other stakeholders.

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PART A

Introduction

1. The Second Session Energy Bill introduces a power for the Secretary of State to designate a new document, a Strategy and Policy Statement (SPS), subject to certain conditions. It introduces a transparent process to improve alignment between the Government's strategic energy objectives and regulation of electricity and gas markets by the independent regulator, Ofgem, while respecting Ofgem's independence in making regulatory decisions.
2. This note is intended to provide background to inform debate during the passage of the Bill through Parliament and for industry, consumer, environmental and other stakeholders.

Part A:

- explains the background and the Government's intentions;
- outlines the provisions and how they would work, noting the limited changes from the draft Bill,
- covers questions raised following publication of the draft Bill.

Part B:

- indicates the possible structure of the first SPS and the issues and considerations for Government in its development.

Context for proposals

3. The *Principles of Economic Regulation*¹, April 2011, set out the importance of having a stable and predictable framework for investment and growth across the infrastructure sectors, and committed to introduce "strategy and policy statements" (SPSs) for each of the regulated sectors.
4. The *Review of Ofgem*², July 2011, concluded that the role of the regulator had become more complex than originally envisaged and that there was a lack of clarity over the roles of the Authority and Government which could cause regulatory uncertainty.
5. The Review recommended a strategy and policy statement to set out strategic priorities, describe roles and responsibilities and define policy outcomes that Ofgem has an important role in delivering. The Review also concluded that the principal objective should

¹ <http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation>

² http://www.decc.gov.uk/en/content/cms/meeting_energy/markets/regulation/regulation.aspx

“remain essentially unchanged, recognising the benefits that this stability could provide for investors”.

6. The *Draft Energy Bill Command Paper*³, May 2012, contained draft provisions for powers to introduce a SPS and outlined this background and the Government’s intentions in relation to the provisions: to provide a mechanism for ensuring closer alignment between Government policy and the Authority’s regulatory functions in the medium term and to enhance regulatory predictability. The SPS would not change the Authority’s (or the Secretary of State’s) principal objective of protecting the interests of present and future consumers but, subject to this, would require the Secretary of State and the Authority to carry out their functions in the manner best calculated to further the delivery of specified policy outcomes.

Legislative provisions in the Energy Bill

7. Part 4 of the Energy Bill sets out:
 - a. a power for the Secretary of State to designate a SPS, subject to requirements for consultation and parliamentary approval;
 - b. what the SPS must contain: the strategic priorities and other main considerations of Government in formulating energy policy; policy outcomes to be achieved as a result of the implementation of that policy; and a description of the respective roles and responsibilities of the Authority and the Government (and potentially others);
 - c. the duties of the Secretary of State and the Authority in relation to the SPS;
 - d. procedural requirements for consultation and Parliamentary approval which must be satisfied before the Secretary of State may designate the SPS;
 - e. the process for reviewing the SPS at least every 5 years; and
 - f. annual reporting requirements for the Authority.
8. It also repeals provisions concerning the Social and Environmental Guidance to which the Authority currently has to have regard in carrying out its regulatory functions. The Ofgem Review found this to be ineffective and it will be superseded by the SPS.
9. The Authority’s principal objective - to protect the interests of existing and future consumers - remains the same, but both the Secretary of State and Ofgem will be required to carry out their regulatory functions in a manner best calculated to further the delivery of the policy outcomes.
10. There were only minor changes between the draft and final Bill on detailed wording which did not change the effect of the provisions.

³ <http://www.official-documents.gov.uk/document/cm83/8362/8362.pdf>

Views on the SPS provisions in the draft Energy Bill

11. Neither the Energy and Climate Change Committee nor the informal Lords working group scrutinised the draft SPS provisions, for reasons of time. Nonetheless, a small number of responses to the ECC Committee's call for evidence offered views or raised questions on the following issues: the implications for Ofgem's independence, how the mechanism would work, how often the SPS would be reviewed and how consultation would work.
12. The Government considered the questions and points raised but does not consider that they justified changing the provisions. **However, the following comments may be helpful for understanding the provisions.**

Implications for Ofgem's independence

13. The provisions are intended to strengthen the regulatory framework and clarify roles without compromising regulatory independence. The EU Third Energy Package (the "Third Package") comprises two directives and three regulations which govern the internal market in electricity and natural gas, and which impose significant constraints on the regulation of energy in a Member State⁴. The Secretary of State has a duty to comply with the Third Package in the same way as he is obliged to comply with all EU legislation. This is specifically recognised in clause 111 of the Energy Bill.
14. The Government will focus on setting out strategic policy and identifying policy outcomes in the SPS which relate to what Ofgem should achieve. The SPS will not specify how Ofgem is to achieve those outcomes. The Government does not intend to make frequent changes or to specify outcomes in a way that would compromise Ofgem's independence. This intention is reflected in the provisions in the Bill. The requirements on consultation and Parliamentary approval that need to be satisfied before the Secretary of State can designate a SPS, and the conditions for a review of an SPS mean that revision of the SPS will be a significant undertaking which would take some time.
15. Ofgem's principal objective remains the same but the new legislation will require the Authority to have regard to the strategic priorities in the SPS in carrying out its regulatory functions and (subject to its duty to further the principal objective) to carry out those functions in the way it considers best calculated to further delivery of the outcomes.
16. It will be for Ofgem to develop and report against a strategy to further the delivery of the policy outcomes contained in the statement.
17. The legislation makes provision for the Authority at any time to give notice to the Secretary of State if it concludes that a policy outcome is not realistically achievable.

⁴ The Directives are Directive 2009/72/EC and Directive 2009/73/EC. The relevant EU Regulations are [the Agency Regulation \(Regulation \(EC\) No. 713/2009\)](#); [the Electricity Regulation \(Regulation \(EC\) No. 714/2009\)](#); and [the Gas Regulation \(Regulation \(EC\) No. 715/2009\)](#) as amended by [the Commission Decision of 10 November 2010 \(Commission Decision 2010/685/EU\)](#).

18. The Government will also need to consider the Third Package in developing the SPS itself. For example, the policy outcomes will express what outcome is sought, not how Ofgem should act.

How the SPS would work

19. The reporting provisions are important for accountability and transparency in how the SPS will take effect. Ofgem is required to draw up, before each financial year, a forward work programme. In future, the forward work plan will be required to set out the strategy Ofgem intends to adopt to further the delivery of the policy outcomes. Ofgem is also required to make an annual report to the Secretary of State which the Secretary of State is required to lay before Parliament. In future, the report will be required to cover the extent to which Ofgem has implemented its strategy and contributed to the furthering of the policy outcomes in the SPS.
20. Accountability and transparency already form part of Ofgem's statutory duties. The planning and reporting requirements in the Bill are expected to enhance this accountability and to help ensure that the SPS is well integrated into the regulator's plans and decision-making.

Consultation and review

21. Consultation will be important given the effect of this instrument, to ensure the priorities and outcomes are well-chosen and do not have unintended effects. As well as the statutory requirements for consultation, we would expect to engage informally with a range of stakeholders, to ensure the draft is based on good quality information. The Government must consult Ofgem and Scottish and Welsh Ministers on the draft and make any changes it considers appropriate before a further consultation of these consultees and others that the Secretary of State considers appropriate. We intend that this would be a wider, public consultation. . The draft statement and a report on the consultation and any changes would be laid before Parliament for approval by a resolution of both Houses, before the Secretary of State could designate it.
22. Where the SoS amends an SPS following a review. the amended statement must be consulted on, and approved by Parliament, in accordance with the procedure outlined above, before it can be designated.

Timing of the first SPS

23. Following Royal Assent, the two-stage consultation on the draft statement will be required, followed by Parliamentary approval and designation. The current aim is to prepare a draft SPS for consultation in 2014.

PART B – STRATEGY AND POLICY STATEMENT: INDICATIVE OUTLINE, CONTENT, ISSUES

Part 1 Introduction

Drafting notes and considerations for Government

Purpose: This part will explain the purpose of the SPS, how it relates to the principal objective, and how it will be updated.

Points that the Government will need to consider

* Draft text is included as an indication, and subject to the passage of the Energy Bill.

* The extent of the background history. For example, there may be limited value in including material that has been thoroughly rehearsed in Parliament.

1.1 Background

1.1.1 This Strategy and Policy Statement is designed to improve the alignment between the Government's energy objectives and regulation of energy markets by the Gas and Electricity Markets Authority (GEMA). It is designated under the [Energy Act 2013].

1.1.2 In April 2011, the Government reaffirmed its commitment to independent economic regulation across the infrastructure sectors in its *Principles for Economic Regulation*⁵. This set out the importance of stable and predictable regulatory frameworks for investment and growth across the infrastructure sectors, and committed to introduce strategy and policy statements for each of the regulated sectors to provide context and guidance about priorities and desired outcomes.

1.1.3 In the *Ofgem Review Final Report*⁶, July 2011, the Government confirmed that it intended to strengthen the existing regulatory framework for energy by bringing greater clarity and coherence to the roles of both Government and the regulator; GEMA, and its executive arm, Ofgem (both referred to here as 'Ofgem'). To achieve this, the Government proposed to establish a new statutory Strategy and Policy Statement.

1.1.4 The Review's conclusion and proposals responded to significant changes that have occurred in the context in which Ofgem works since economic regulation was established in

⁵ <http://www.bis.gov.uk/policies/better-regulation/improving-regulatory-delivery/principles-for-economic-regulation>

⁶ http://www.decc.gov.uk/en/content/cms/meeting_energy/markets/regulation/regulation.aspx

the 1980s. The role of the regulator is now much more complex than originally envisaged, with an important contribution to make to Government's policy goals for the energy sector, for example energy security or climate change objectives.

1.1.5 The Review concluded that:

- A lack of clarity over respective roles has developed which may cause regulatory uncertainty;
- Government should set a clearer strategic direction for energy; and
- There is a need for greater transparency as to how Ofgem's independent regulatory decisions should be aligned with this direction.

1.2 Role and purpose of document; relevant legislation; how it relates to the principal objective

1.2.1 The Strategy and Policy Statement is designed to clarify the existing regulatory framework and increase regulatory certainty by requiring Government to be clearer about its strategic policy framework. The [Energy Act 2013] established a transparent and enduring process for this. This includes stronger accountability arrangements than for the Social and Environmental Guidance which was repealed by the Act. The Act introduced new duties but did not change the Authority's principal objective to protect the interests of existing and future consumers.

1.2.2 The [Energy Act 2013] provides a power for the Secretary of State to designate a Strategy and Policy Statement subject to certain consultation and parliamentary requirements. The Strategy and Policy Statement is a Statement that sets out:

- the strategic priorities and other main considerations of the Government in formulating its energy policy (**strategic priorities**);
- the particular outcomes to be achieved as a result of the implementation of that policy (**policy outcomes**); and
- the **roles and responsibilities** of persons (whether the Secretary of State, the Authority or other persons) who are involved in implementing that policy or who have other functions that are affected by it.

1.2.3 Ofgem must have regard to the strategic priorities when carrying out its regulatory functions. Both the Secretary of State and the Authority must carry out their regulatory functions in the manner they think best calculated to further the delivery of the policy outcomes, subject to the application of the 'principal objective duty'.

1.2.4 Ofgem is required to draw up, before each financial year, a forward work programme. The forward work plan must set out the strategy Ofgem intends to adopt to further the delivery of the policy outcomes. Ofgem is also required to make an annual report to the Secretary of State which the Secretary of State is required to lay before Parliament. The report must cover the extent to which Ofgem has implemented its strategy and contributed to the furthering of the policy outcomes in the SPS.

1.3 Social and environmental guidance withdrawn

1.3.1 The Statement replaces the previous Social and Environmental Guidance.

1.4 Geographical coverage

1.4.1 This Statement applies to Great Britain [legal ref].

1.5 How it will be updated

1.5.1 The intention is that this Statement will be in place for the life of a Parliament. It must be reviewed after five years following designation. The Secretary of State may also review the statement:

- after a general election;
- if Ofgem gives notice that a policy outcome is no longer realistically achievable;
- if there is a significant change in energy policy which was not anticipated and which the Secretary of State considers would have led to a materially different statement, if it had been anticipated; and
- if Parliament did not approve an amended Statement.

Part 2 Roles and responsibilities

Drafting notes and considerations for Government

Purpose: this section will explain the roles and responsibilities of the main players.

Points that the Government will need to consider

- * Draft text is included as an indication, and would be developed to include relevant aspects and detail.
- * To give a coherent description of existing roles and responsibilities,.
 - * To identify the main players beyond DECC and Ofgem who are significant for delivering energy policy. They might include, for example, National Grid's future role under Electricity Market Reform.
 - * To identify areas of discretion or overlap between the Secretary of State and Ofgem, or with any other parties.
 - * To clarify how the Secretary of State and Ofgem would liaise and engage in relation to action in those areas..

2.1 Department of Energy and Climate Change (DECC)

2.1.1 [DECC sets UK energy policy goals and the framework for achieving them.]

2.1.2 [Main pieces of legislation.]

2.1.3 [Specific functions in the energy sector, including granting consents for power stations; defining the extent of the regulated industry by deciding on licence exemptions; appointing members of the Gas and Electricity markets Authority (GEMA), which sets Ofgem's strategy; having the power of veto on any proposal by the regulator to modify licences.]

2.1.4 [DECC also sets wider social and environmental policy relating to energy, and deals with international energy issues, specifically liberalisation of the EU energy market and imports of oil and gas.]

2.1.5 [DECC leads on energy policy although many other Government departments, and the devolved administrations, also have a considerable interest in it. DECC also looks after other areas such as energy efficiency and fuel poverty.]

2.1.6 [Accountability and transparency.]

2.2 Ofgem

2.2.1 [Ofgem, the independent energy regulator, is responsible for regulation of the energy markets in England, Scotland and Wales. Gas and electricity companies generally need a licence to operate.]

2.2.2 [Ofgem's key functions include: issuing, modifying and revoking licences; setting price controls in the natural monopoly licensed sectors; investigating and penalising those in breach of licence conditions.]

2.2.3 [Ofgem was established by the Utilities Act 2000 and operates independently. This ensures that energy regulation is free from political interference and helps avoid uncertainty in the energy markets.]

2.2.4 [Accountability and transparency.]

2.3 Other

2.3.1 [Possible – other main parties in gas and electricity markets.]

2.4 Areas of overlap

2.4.1 [Identify and discuss areas of overlap.]

Part 3 Strategic priorities and outcomes for energy policy

Drafting notes

Purpose This section will set out the Government’s “strategic priorities and other main considerations of its energy policy”, and the policy outcomes to be achieved as a result of the implementation of that policy. They are intended to be existing policy.

This part could recap the relevant statutory provisions:

- * What a Statement must contain to be an SPS
- * Ofgem must have regard to the strategic priorities set out in the SPS when carrying out its regulatory functions (clause ref).
- * The Secretary of State and Ofgem must carry out their respective regulatory functions in the manner which [they] consider is best calculated to further the delivery of the policy outcomes, subject to the principal objective (clause ref).

Commitments in the Command Paper

The SPS will provide a clear, high level description of Government’s strategic priorities in formulating energy policy.

The intention is that the Statement will include a limited number of short ‘policy outcomes’ that result from high-level strategic trade-offs that Government has made.

It is anticipated that the outcomes will reflect existing policy. New policy measures will continue to be introduced by way of separate processes, and may necessitate changes to the SPS following a review.

Points that the Government will need to consider

- Setting out strategic policy and identifying policy outcomes in the SPS which relate to what Ofgem should achieve. The SPS will not specify how Ofgem is to achieve those outcomes, nor compromise Ofgem’s independence.
- Since the intention is that the SPS will be in place for the lifetime of a Parliament, its content must be relevant for the medium-longer term.
- What priorities and outcomes should be included: the selection process for the draft SPS is currently intended to be around the leading themes for energy policy: security of supply, affordability and low carbon. As part of this, the Government will need to consider the guidance in the Social and Environmental Guidance that be repealed by this legislation.
- The consultation process will enable wider views on the value and potential consequences of particular outcomes, and the combined basket of outcomes, to be considered.
- The “outcomes” are expected to be where Ofgem has a significant role to play

3.1 DECC overarching objectives and priorities; introduction, relevant themes for SPS

Drafting notes

For each section, the *strategic priorities* and *main considerations* for energy policy, for example, to include why this is important, what the evidence and analysis's, what the options are and therefore what the Government's goals are:

For example:

- 3.1.1 [Text on why energy is fundamental to our economic prosperity and social well-being; the Government's vision and aims including why it is important to ensure that the UK has secure and affordable energy supplies; to playing our part in international efforts to prevent dangerous climate change by reducing the country's greenhouse gas emissions by half by around 2025 and by at least 80% by 2050, compared to 1990 levels, to delivering energy policy in a way that maximises the benefits for jobs and investment, sourcing 15% of our energy from renewable sources by 2020, managing the nuclear legacy safely and to least cost and affordable energy for consumers.]
- 3.1.2 [Refer to current position, evidence and analysis.]
- 3.1.3 [Further text as needed on UK policy goals where Government considers Ofgem has a part to play.]
- 3.1.4 [Text on Electricity Market Reform, to show direction of travel and goal.]

3.2 Security of supply

- 3.2.1 [Text on why it is critical that the UK continues to have secure and reliable supplies of electricity as we make the transition to a low carbon economy. To manage the risks to achieving security of supply we need:
 - Sufficient electricity capacity (including a greater proportion of low carbon generation) to meet demand at all times;
 - Gas supplies, etc]
- 3.2.2 [Medium and longer term challenges]
- 3.2.3 [Need for energy infrastructure, such as new power stations and electricity networks, to support these objectives]
- 3.2.4 Policy outcomes

Drafting note

To include more specific text on the 'main considerations' relevant for the selected 'policy outcomes', and the outcomes themselves

The outcomes would relate to one or more of the themes, and would be relevant for the medium or longer term.

3.2.5 [...]

3.3 Affordability

Drafting note

This section would follow the same pattern in principle.

3.4 Low carbon

Drafting note

This section would follow the same pattern in principle

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