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28 October 2010

To the Consultation Team:

Implementation of the European Union Third Energy Package: Consultation on Licence Modification Appeals

Energy Networks Association (ENA) is funded by the major licensed electricity and gas transmission and distribution companies in the UK and Ireland. We provide a collective voice for those companies on matters of significant concern.

We welcome this opportunity to respond to DECC's consultation document on licence modification appeals. The proposals in question were first raised in DECC's main consultation earlier this year on the implementation of the EU Third Package. DECC's subsequent decision to bring forward those proposals in a more developed form and to expose them to a self-contained consultation is very sensible. This is because, if implemented, the proposals would fundamentally change an enduring design feature that has been present within the UK energy regulation regime ever since the industry privatisations of the 1980s.

That design feature is a statutory framework within which Ofgem: (1) can modify licence conditions having first obtained individual or majority consent to do so, (2) can refer the matter to the Competition Commission for investigation if such consent is not obtained, and (3) can then modify the licence if the Commission has determined that the proposed modification is in the public interest.

Each of those key design elements would change under DECC's consultation proposals, in that: (1) Ofgem would be able both to propose and impose licence modifications, subject only to (2) the right of licence holders to appeal against a modification to the Competition Commission, where (3) the matter would be decided by reference to tightly focused grounds of appeal rather than a public-interest test.

The fundamental nature of these changes should not be understated. DECC therefore has a particular responsibility to demonstrate the need for change.

DECC has justified its proposals to rewrite the current UK energy legislation in order to create an entirely new process for making and challenging licence modifications on the basis of a legal interpretation of the directives in question. However, dealing first with the issue of regulatory independence, we are not satisfied that the case has yet been made for interpreting the requirement for Ofgem to take autonomous decisions as meaning that the UK licence modification process must be changed.

DECC's approach appears to misread the relevant text of the directives in respect of regulatory autonomy: see articles 35(5)(a) for electricity and 39(5)(a) for gas. The language of these provisions is identical: both are designed specifically to ensure that the regulatory authority is able to take autonomous decisions, independently from any political body. The provisions therefore relate to the extent of the autonomy to be enjoyed by a regulatory authority in its relations with the institutions of government. In that context, there is nothing in the UK licensing regime (with the possible exception of the power of government ministers to veto any licence modification that has not been endorsed by the Competition Commission) that encroaches on the autonomy of Ofgem's decisions under the modification process.

With regard to the proposed appeals process, the consultation document asserts that a mechanism over and above the ability of licensees to bring a claim for judicial review is required as a means of holding Ofgem to account for decisions that comprise essentially issues of a technical or economic nature. However, it is by no means clear that the relevant provisions of the Third Package in respect of appeal rights do require anything more than unfettered access to judicial review (which is always available under UK law when any energy licence modification is made). Why otherwise would the relevant provisions in the directives (for gas and electricity respectively, see paragraphs 34 and 37 in the recitals and articles 41(16) and 37(16) in the operative text) refer repeatedly to judicial review as an appropriate standard for Third Package appeals?

EU principles of legal interpretation require a purposive approach to the Third Package appeal requirements. On that basis, the best reading is surely that both the directives are saying no more than that decisions must be made in sufficient detail to facilitate judicial review, and that judicial review (or an alternative appeal mechanism that is at least equivalent to it) must be available.

In any event, if on a proper reading of the directives it really is necessary to provide something different from judicial review for appeals against regulatory decisions, why does DECC suppose that it is only Ofgem's licence modification decisions that are covered by that interpretation? Ofgem makes many decisions having regulatory effect (such as when it makes regulations, or gives directions or consents, or determines disputes, or grants or revokes licences) that are not in the form of licence conditions but are certainly of equal economic significance. Licences are only one administrative route by which the UK system empowers the regulator to regulate the industry. On that basis, if DECC's legal interpretation of the directives is correct, then any regulatory decision by Ofgem should be appealable in substance (i.e. beyond judicial review), regardless of the particular discretion or power that facilitates the decision, so long as it is directed at one one or more of the matters covered by the Third Package.

ENA acknowledges that the judicial review process is a limited means of challenging substantive regulatory decisions. Nevertheless, we have seen nothing in DECC's current document that shows a compelling requirement to alter licence modification processes in order to ensure UK compliance with the Third Package. The legal interpretation driving DECC's consultation (including the contention that the existing regime compromises Ofgem's ability to make autonomous decisions) is asserted rather than argued. If the reason for changing a mechanism that affects licencees' property rights really is a legal requirement, rather than a policy preference, then DECC has a responsibility to lay out the legal argument carefully and to publish the full analysis behind it. This consultation will remain incomplete until that is done.

Even if the need for fundamental changes to the energy licensing regime to secure UK compatibility with the directives can be clearly shown, ENA could not support the consultation proposals without a satisfactory resolution of a number of significant concerns. These are set out in the paper attached for DECC's consideration. We also request full disclosure of the legal analysis and argument that have led DECC to conclude that the UK's long-standing energy licence modification arrangements are incompatible with the Third Package requirements for rights of appeal. Given the very tight timeframe for implementing any changes, we would welcome further discussions with DECC as soon as possible before final decisions are made.

We hope that our comments will be useful. In the interests of transparency, we have copied this response to Ofgem.

Yours sincerely

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CONSULTATION ON LICENCE MODIFICATION APPEALS:

ENERGY NETWORKS ASSOCIATION'S COMMENTS

This paper supplements ENA's letter dated 28 October 2010, which states that even if DECC's consultation proposals can be shown to be necessary to ensure UK consistency with EU requirements for rights of appeal against Ofgem's decisions, the concerns set out below will need to be resolved satisfactorily to secure ENA's support.

In our view, the Third Package is primarily concerned with facilitating integrated and competitive markets for electricity and gas through regulated network operators that act independently of supply and producer interests. In the electricity and gas directives within the package, the reference to autonomous decisions by the regulatory authority is set in the context of independence from any political body. On that basis, although it is clear that Ofgem must be able to make binding decisions in carrying out its tasks under the directives, this is in relation to such matters as approval of charging methodologies and the use of Ofgem's enforcement powers. **None of this implies a need for the wholesale replacement of the current UK process for licence modifications.**

The general statutory context for DECC's proposals

We understand that DECC intends to use its powers under section 2(2) of the European Communities Act 1972 to implement the proposals. That legislative provision enables ministers to make statutory instruments in order to bring UK law into line with Community law when they are required to do this by European legislation. In relation to the two directives within the Third Package, the power that is conferred on DECC by section 2(2) is a power to amend UK law to achieve the results specified in those directives.

A particular result that is specified by the directives is a right of appeal in relation to decisions taken by Ofgem, including, by implication, licence modifications that may be necessary to meet Third Package requirements (unless these are achieved through legislation). Those decisions do not apply to all licence categories, and still less do they apply to all modifications of conditions within a specific licence category regardless of their subject matter. The Third Package only requires changes to UK law in relation to the particular matters within its scope. DECC's proposals contravene that principle because they would apply to all Ofgem's licence modifications, across all categories of licence, and not only to those that may be covered by Third Package requirements.

DECC's rationale for taking this course is explained in the consultation document at paragraph 1.7. The minimum implementation option, resulting in two parallel but linked processes for making licence modification decisions, would clearly be more complex and more costly than DECC's chosen option. However, while it may be permissible, within the margin of appreciation accorded to Member States, to exceed the strict requirements of the directives for domestic policy reasons, we do not believe that it is permissible to make changes that actually go beyond the legal scope of the Third Package without enacting primary legislation for that purpose.

Given the fundamental nature of the changes in question, we think it is imperative that DECC does not implement them on a basis that could be legally flawed and hence susceptible to challenge.

Taking account of the merits of the case

We believe it is essential that the proposed new regime should do what it claims, and provide a mechanism that really is an appeal on the merits of the case and not just on factual or process issues. It is not clear that this would be so under the consultation proposals. Despite DECC's assertion that a mechanism over and above an ability to bring a claim for judicial review is required, the five grounds of appeal that are actually proposed (failure to have regard or to give proper weight to statutory duties, failure to observe due process, and error of fact or of law) are in most respects indistinguishable from the standard grounds for UK judicial review proceedings.

The proposed grounds are also effectively the same as those available in the industry code appeals regime established under the Energy Act 2004. In the only appeal brought against an Ofgem code modification decision under that regime within the past six years, there was much debate before the Competition Commission about the nature of its jurisdiction in the case. The Commission finally took an expansive view and decided that the language of the grounds of appeal allowed it to go beyond a narrow judicial review approach and to take account of the merits of the case. However, that decision could have gone the other way without necessarily being legally invalid.

Given such uncertainties about the actual nature of the jurisdiction envisaged by the consultation proposals, we believe it is important to put the matter beyond any possible doubt by establishing on the face of the implementing legislation that the Competition Commission, whether acting in an adjudicative role or an investigative role, is required to take the merits of the case into account. This could be achieved by providing that the Commission must determine the appeal on the merits of the case and by reference to the grounds of appeal (see above) specified by the appellant. Section 195 of the Communications Act 2003 (which provides for the jurisdiction of the appeals body in appeals against Ofcom's regulatory decisions) provides a sensible precedent for the statutory specification of the merits approach and could be suitably adapted for licence modification appeals.

Treatment of licence modification packages

Licence modifications are usually made in the form of bundled packages, particularly (though not exclusively) in respect of price control determinations. This raises two issues which will need to be resolved in relation to the consultation proposals.

1. The first issue arises from the fact that price control determinations increasingly now rely on standard as well as special licence modifications: for example, the recent DPCR5 settlement included 18 standard licence modifications in addition to19 special modifications. DECC's proposals, however, envisage different processes and potentially different Competition Commission powers of disposal for each distinct category of appeals. The easiest solution to this problem is to require that where a price control

package containing any standard licence modifications is under appeal, the different process and potentially different powers reserved for price control matters must apply to those modifications as well as the special ones.

2. The second issue may be more difficult. It arises because DECC's proposals are silent on how and to what extent licence modifications would be able to be disaggregated and treated separately from each other on an appeal. In relation to an appeal against a price control determination, in particular, the question that requires to be answered is whether the appeal would have to be treated in the round as a challenge to a package of inter-related modifications, none of which could be addressed separately, or whether the licensee would be able to specify which particular licence modifications within the determination package were to be the subject of the appeal.

Historically, regulators have always presented price control determinations, and licence holders have always considered and then accepted or rejected them, as a balanced package of components. The package is claimed to bring together both the rough and the smooth, each element erring to some extent either in favour of the licensee or against it because, actually, none of the elements can be fixed or calculated with absolute precision. Then, on a Commission reference, while all of the elements are certainly assessed individually, they are finally subjected as an overall package to a broad and potentially open-ended public interest test.

While this approach is not without its merits, it also has some significant downsides. In particular, it leaves the licensee with little if any control over the terms of the reference. In addition, it does not incentivise the regulator (including the Competition Commission as the regulator of last resort) to be fully rigorous in its approach to each specific component of the price control methodology. In a new regime, where the licensee itself rather than Ofgem would have a positive right to instigate the appeal process, and to do so by reference to specific grounds of appeal that are selectable at the licensee's own option, the changed dynamics may well demand that licence modification packages should be capable of disaggregation for the purposes of challenge.

The methodology by which a regulator's price control determination is arrived at is, in effect, additive. Accordingly, the ability to treat each individual component within a price control determination as a separable element that is liable to be challenged as such would strengthen the incentive on Ofgem to ensure that its decisions in respect of each of those components are correct. This should reduce the likely incidence of such appeals. It would also be directly in the public interest, because good regulation depends upon the components of the package being right, not just on the overall balance being felt to be acceptable. **We therefore recommend that the design of the new regime should enable a licensee to challenge a price control modifications package either in the round or on a disaggregated basis.**

Consequential impact on collective modifications

Another critical issue on which DECC is silent is the impact of the consultation proposals on the nature and operation of the collective modification procedure for the standard licence conditions. The basic principle of the current standard licensing regime is that

all licences of a particular type should contain the same conditions and should be subject to modification in the same way and at the same time.

The collective licence modification procedure is designed to give effect to that principle. Where a licence modification has been referred to the Competition Commission because Ofgem has failed to obtain the required level of support for it, and the Commission makes adverse public interest findings, Ofgem is then able to modify all licences of the type in question. Assuming the continuation of that approach, DECC's proposals would produce a situation in which all of the licences of a particular type would be modifiable by reference to the outcome of a single appeal made by a single appellant. This would be regardless of the wishes of any other holders of that type of licence, and pursuant to a process which had not engaged them and to which they had not been parties.

To preserve both the procedural and the substantive rights of all of the relevant licensees in this situation, it will be necessary to allow any and all of them the right to be treated as additional parties to an appeal. The rationale for this is that in principle all the licensees within a particular category of licence are likely to be materially affected by the outcome of an appeal, and it is hence appropriate that they are able to be fully engaged in the appeal process. Paragraph 2 of Schedule 22 to the Energy Act 2004 (which sets out the rules of engagement for appeals against Ofgem's code modification decisions) deals with the difficult procedural and other issues arising from the right to become an additional party in a way that could be suitably adapted for licence modification appeals.

Third-party rights of appeal against modifications

The possibility that rights of appeal against licence modifications might be granted to third parties as a result of the current consultation is a very significant concern for ENA members. Such rights, whether for licensees who do not hold the type of licence that is being amended or for consumer organisations and other stakeholder interests, are not compatible with the particular legal nature of the UK's licensing regime. If granted, they would greatly diminish the role of Ofgem in the regulatory process and tend to make the Competition Commission the forum in which (in particular) energy network price controls would usually be determined.

We acknowledge that the appeals process of the Energy Act 2004 confers rights of appeal on third parties who are materially affected by a code modification decision, including bodies representative of persons so affected. However, we firmly contend that this precedent should not be adopted for licence modification appeals. The industry codes are multilateral contracts which impose obligations on, or constrain the behaviour of, a very wide range of industry parties holding different types of licence under a governance framework in which consumer groups and other third-party interests are explicitly represented. It is therefore appropriate that such third parties (if their interests are materially affected) should be able to exercise the same rights of appeal against code modification decisions as those who are directly parties to the code.

A licence, in contrast, is not a contract setting out the terms and conditions on which one party will provide services to another. It is a very different kind of legal instrument

from a contract. This is because it is designed to constrain the behaviour of one person, and one person only – the licensee as the owner of the regulated assets – for the benefit of society. A licence is a statutory permission for a person to undertake an activity that would otherwise be unlawful, subject to the requirements imposed by the conditions of the licence: it controls the bilateral relationship between the licensee and the regulator, and creates obligations for no one except the licensee itself. **Direct rights of appeal should therefore be granted only to the person on whom the licence places those direct burdens.**

That is the argument from principle against the grant of third-party appeal rights against licence modifications. A more pragmatic objection is the undesirable diminishing of Ofgem's role in the regulatory process that would follow almost inevitably from the grant of appeal rights to parties other than the licensee. This would particularly be the case with the role of the regulator at a price control review. Instead of conducting a review that is essentially a bilateral process, in the sense that it must of necessity be focused on delivering a set of proposals targeted at the licensee that the licensee can accept or reject, Ofgem would instead be conducting a review where the end product is a set of proposals that, if they are to become effective, must receive the approval not only of the licensee but of all the other parties that claim to have a right to be satisfied.

In those circumstances, Ofgem's role would rapidly become merely mediative rather than decisive because all parties would know that any of the other parties could force the matter to the Competition Commission. This would change the regulator's behaviour, giving it more of an honest-broker role between all of the parties than the leadership role that it has now. Its review would tend to become largely exploratory in nature, and it would soon find its freedom of manoeuvre restricted to facilitating a multilateral debate between all those parties that had rights of appeal. There would be only one real price control review, and that would be the merits appeal at the Competition Commission.

It should be noted that both the argument from principle and the pragmatic objection are rooted in the particular nature of the relationship between the regulator and the regulated company in an industry that is regulated pursuant to a licensing regime. To that extent, they are two sides of the same coin. The right to appeal against a change to the licence should accordingly be conferred only on those whose property rights are being interfered with under that licence in the public interest. **Third-party interests should have no substantive right to initiate or be joined into a licence modification appeal. Their role should be limited to an ability to provide support and evidence on either side of an appeal at the discretion of the Commission – as is the case now with all references to it.**

Suspensive effect of an appeal when brought

The consultation proposals envisage (as under the Energy Act 2004 appeals regime) a discretionary power for the Commission, on application by the appellant, to suspend the effects of the challenged licence modification while the appeal is running. This is unlikely to be sufficient in most of the cases that could come before the Commission on appeal. Most types of UK energy licence have evolved over nearly 25 years of regulation into an advanced state of maturity in which almost any significant modifications (not confined

to those required for a price control determination) are now likely to have material and irreversible adverse cost implications for the licence holder, whether by way of necessary system/process alterations, or a requirement for new compliance arrangements, or both. **We therefore believe that suspension of the effects of a challenged decision should be a standing presumption of the process and that it should be for Ofgem to demonstrate otherwise to the Commission.**

Costs of appeal and powers of dismissal

We agree with DECC that appeals with a reasonable chance of success, and regulatory decisions that are unlikely to attract a successful appeal, should not be deterred by considerations of cost and that it should therefore be possible for the winner's costs to be paid by the loser. However, given the range of the remedies at the Commission's disposal, it might sometimes be very difficult to establish precisely who is the winner and who has lost in any specific case. A wide discretion for the Commission to award costs in whole or in part on either side of an appeal is the appropriate solution, including a discretion to penalise parties for wasting time with poor or irrelevant arguments or for fighting hopeless points. We also agree that the Commission must be able to dismiss trivial and/or vexatious appeals.

Conclusions and next steps

As noted above, the consultation proposals would fundamentally change some of the key enduring design principles of the licensing regime for the regulated energy sector. DECC's published document on what is proposed and how it would work is incomplete and unclear in some important respects that are highlighted in this response.

We have not seen a compelling case for a wholesale replacement of the current UK process for energy licence modifications in order to comply with the Third Package. Accordingly, ENA could not support the consultation proposals without a satisfactory resolution of the concerns set out in this paper. That would include full disclosure of the analysis and argument that have led DECC to conclude that the UK's long-standing licence modification arrangements are incompatible with Third Package requirements for rights of appeal.

Energy Networks Association

October 2010