Energy Bill: Energy Industry Code Reform

Lead department	Department for Business, Energy and Industrial Strategy
Summary of proposal	To reform the governance structure to ensure that energy codes promote effective competition and keep pace with technical and commercial developments within the electricity and gas markets.
Submission type	Impact assessment (IA) – 22 December 2021
Legislation type	Primary legislation
Implementation date	2024
Policy stage	Final
RPC reference	RPC-BEIS-5077(2)
Opinion type	Formal
Date of issue	27 January 2022

RPC opinion

Rating[1]	**RPC opinion**
Fit for purpose	The IA considers the impacts of the strategic body function that will be introduced via primary legislation and provides illustrative impacts of the secondary legislation on the code management function. The IA has clear rationale for intervention and provides a detailed monitoring and evaluation plan.

Business impact target assessment

	Department assessment	**RPC validated**
Classification	Non-qualifying regulatory provision (pro-competition)	To be determined at secondary legislation IA stage
Equivalent annual net direct cost to business (EANDCB)	Not quantified	No impacts from the primary legislation are in scope of the BIT. Further IAs to be submitted for related secondary legislation and/or regulator stages for validation of an EANDCB figure
Business impact target (BIT) score	Not quantified	See above
Business net present value	Not quantified	
Overall net present value	-£17.0 million	

[1] The RPC opinion rating is based only on the robustness of the EANDCB and quality of the SaMBA, as set out in the Better Regulation Framework. RPC ratings are fit for purpose or not fit for purpose.

RPC summary

Category	Quality	RPC comments
EANDCB	Green	The Department has not submitted an EANDCB figure for validation at this stage, but the IA summarises the impacts for various stakeholders. The Department must present an EANDCB figure for the final stage IA on the related secondary legislation for code management.
Small and micro business assessment (SaMBA)	Green	The IA has identified the number of small and micro businesses (SMBs) within the electricity and gas sectors. The IA provides an adequate discussion of the proposal's impacts on them.
Rationale and options	**Good**	The IA presents a clear rationale for intervention and explores the market failures that the current arrangements pose – this is supported by evidence. The IA appraises the preferred option and summarises the alternative options previously considered by the Department.
Cost-benefit analysis	**Satisfactory**	The IA provides an adequate analysis of the proposal's impacts and discussion on the risks, sensitivities and assumptions for the costs of the strategic body and code management functions.
Wider impacts	**Satisfactory**	The IA provides a high-level assessment of the proposal's impacts on competition, price, the environment and supply security.
Monitoring and evaluation plan	**Good**	The IA presents a comprehensive monitoring and evaluation plan, outlining the objectives, data requirements and the approaches for the process and value-for-money evaluations to be conducted in 2027 and 2032, respectively.

Summary of proposal

At present, the energy sector is governed by industry-led codes with oversight from the regulator, Ofgem. The 2016 ‘Energy Market Investigation Final Report’, by the Competition and Markets Authority (CMA), concluded that the current codes lack strategic direction, are costly for firms to engage with and act as a barrier to pro-competitive and innovation changes. Thus, it is likely to have an impact on the ability of achieving Net Zero at least cost.

The proposal seeks to reform the energy industry code governance structure through primary legislation that would assign Ofgem as the strategic body. This would be complemented by related secondary legislation that would introduce an enhanced code manager function assigned to separate organisation(s). It is anticipated that Ofgem, as the strategic body, would be responsible for setting a strategic direction, based on the Government’s policy priorities, and trends in the wider energy market, as well as ensuring that code managers deliver it.

The IA estimates the impacts of the primary legislation to have a net present value (NPV) of -£17 million over a 10-year appraisal period, due to increased resource demands of Ofgem assuming and conducting the strategic function. As it is expected that these costs will be recovered from industry, these direct impacts to business would be out of scope, under the taxes or levy exemption and, therefore, excluded from the BIT score. However, the Department is encouraged to include its estimates for the business NPV for the primary legislation, which should be equivalent to the impacts passed through to business from Ofgem. Further, the IA presents an illustrative NPV of -£295 million, should the impacts of the code management, introduced in secondary legislation be included.

EANDCB

The Department has not submitted an EANDCB figure for validation at this stage, explaining that clarity on the likely impacts will not be determined until the related secondary legislation is developed. This aligns with the RPC’s guidance on primary legislation whereby the IA provides an indication of likely scale of impacts but is unable to provide a robust assessment for validation. The RPC would expect the Department to submit further IAs for validation when the related secondary legislation is developed.

The IA provides a useful summary of the distribution, and profile, of impacts across various stakeholders (table 6) and provides an illustrative assessment of the impacts of implementing the code management function. It anticipates that this could be reflected in an NPV of -£295 million and applies appropriate sensitivity analysis to test for uncertainties and assumptions, including learning and familiarisation costs. When submitting an IA for the proposed secondary legislation on the impacts of the code management function, the Department is encouraged to monetise as many of the impacts and submit an EANDCB figure for validation, which makes clear the distinction of direct and indirect impacts for the private and public sectors, even if it is a non-qualifying regulatory provision (pro-competition).

BIT classification

The RPC has reviewed the Department's pro-competition assessment and considers that further evidence against the fourth criterion, "*it is reasonable to expect a net social benefit from the measure*" needs to be provided in the IA for the related secondary legislation.

SaMBA

The IA provides more evidence to support the likely impact on SMBs. The IA draws upon evidence that suggests "*smaller firms are … disadvantaged by current governance arrangements, which inhibit fair competition*". It provides a useful summary of the number of SMBs and their growth in the electricity and gas sectors and discusses the current issues faced by SMBs from the status quo. The SaMBA discusses the proposal's impacts on SMBs, noting increased fees to Ofgem, but several benefits including lowering the ongoing administration burden of compliance with the codes. The IA concludes that the anticipated benefits and savings are expected to outweigh the short-term administrative burden and familiarisation costs. However, the Department should consider the impacts of the increased fees that apply to SMBs and assess whether these costs disproportionately affect them and, if so, discuss any courses of mitigation, where appropriate.

Rationale and options

The IA presents a clear economic rationale for intervention using findings from the CMA report to demonstrate the market failures within the existing governance arrangements. This includes barriers for new entrants and smaller firms, which are found to be disadvantaged by the current governance arrangements due to fragmented and complex arrangements; although the IA notes a change in the market structures, illustrating the recent growth in SMBs in the energy sector since 2013. The IA also identifies asymmetric information problem between government and regulator, and the industry participants.

The IA analyses the impacts of the preferred option, for which the IA has noted strong support in the consultation, against a do-nothing baseline. It summarises the discounted options discussed on the structure of the strategic body and code management in previous IAs.

Cost-benefit analysis

The IA provides an adequate analysis of the proposal's impacts and discussion on the risks, sensitivities and assumptions for the costs of the strategic body and code management functions. The Department has undertaken more work on the costs and benefits of the, now, preferred option and the assessment provides a better estimation of the impacts. The RPC commends the Department for using case studies as evidence to support the un-monetised benefits and switch analysis. The Department will need to provide more evidence in the IA supporting the related secondary legislation to fill at least some of the gaps in the present IA's estimation of benefits.

Wider impacts

The Department has improved its assessment of wider impacts. The IA provides a high-level assessment of the proposal's impacts on competition, price, the environment and supply security. The IA anticipates that the proposal will enable increased innovation across the energy system, and possibly reduced energy prices and bills. Further, the proposal should benefit the safe operation of the energy market and supply security, through clearer and more appropriate technical standards. The IA notes no impacts on equality, justice or human rights.

Monitoring and evaluation plan

The IA provides a cogent monitoring and evaluation (M&E) plan and sets out its planned value for money evaluations. The IA illustrates a theory of change (annex 2) for the energy industry code reform and presents a comprehensive M&E plan. The plan outlines the objectives and sub-objectives, data requirements and the approaches for the process and value for money evaluations conducted in 2027 and 2032, respectively. The RPC commends the Department for providing the detail in the IA.

Regulatory Policy Committee

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