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Energy Markets and Consumers
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URN 14S/271 STRATEGY AND POLICY STATEMENT: A CONSULTATION ON THE DRAFT STATEMENT

Response by the Energy Policy Group, University of Exeter

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Thank you for the opportunity to comment on the draft Strategy and Policy Statement (SPS). This comment is set out in the following way: an introduction to our view; responses to your three questions; and a conclusory section of our view what a SPS should include.

Introduction

A key criticism of the Draft SPS is that it does not clarify how the Government wishes to prioritise its goals, or how the trade-offs between them should be made. Ultimately this is because the SPS has not confronted the fundamental tension between 'independent' regulation and the longer term, strategic framework needs of rapidly transforming to a decarbonised energy system.

We are not sure that it is possible, or even beneficial, any longer to have an 'independent' regulator in its current form. We support decision-making based on knowledge, legitimacy, transparency and involvement of stakeholders. It is a time of huge technological change within energy systems. We also need to decarbonise our energy systems rapidly, and this implies a flexible but strategic framework to get there. It therefore seems to us that a CEO, powerful economic regulator, as with the current Ofgem model, is not compatible with enabling the necessary shift in our energy systems.

In that sense, the SPS is an unimaginative document, somehow taking no notice of the changing energy world, nor embedding arguments in support of flexibility. More, it appears to solidify a problematic institutional structure rather than thinking what institutional arrangements would most suit the strategic and policy needs of Government?

An 'independent' economic regulator de facto allows a narrow technical /economic viewpoint to make momentous societal decisions which have major distributional impacts. Currently, the Regulator is then evaluated in a narrow legal sense of meeting its Duties, including ensuring the financial stability of the system. There is no wider evaluation of ensuring an energy system suitable for the longer term needs of society – beyond that of customers - nor does Ofgem have any incentive to act in that way, or penalty if it does not. The SPS has not included such arrangements.

Overall, however, our view is that Government has not taken this opportunity to remove the tensions inherent with the Guidance documents (which have been around since the 1990s) and Ofgem, as an independent regulator, which the Ofgem Review in 2011 highlighted. As such, this SPS has done little to take forward the issues raised in the Ofgem Review.

Answering the Consultation's 3 questions

Question 1: Do consultees consider that the draft SPS clearly sets out the strategic priorities and policy goals for gas and electricity markets and the roles and responsibilities of those involved in delivering them?

Our answer to this question is: No, for the following reasons:

“Having Regard to...”

The draft states that “Ofgem’s duties in regard of the SPS are stronger than those that apply to [the social and environmental] guidance” (p13). However, it is not at all clear how they are stronger. The Ofgem Review concluded that the Guidance was in part ineffective because of its weak legal status compared to Ofgem’s other duties, and weak arrangements for accountability.

Part of the problem with the Social and Environmental Guidance was that Ofgem was only required to “have regard to” it when making its decisions. This condition remains in the SPS (page 12), meaning that in effect the SPS has the same status as the Social and Environmental Guidance. Ofgem may ‘have regard to’ the requirements of the SPS, but having considered them it is under no further obligation to take action.

No Advice on Balancing Priorities

The draft SPS sets out three ‘strategic priorities’ in UK energy policy, which are the three familiar energy trilemma problems of affordability, security and sustainability. However, the draft SPS does not actually *prioritise* between these three and, even more confusingly, it does not provide a clear argument about how they should be treated. Examples of this are:

- Para 15 of Page 17 of the Draft SPS ‘the Authority has a duty to have regard to the need to contribute towards sustainable development and its regulatory decisions should take account of economic, social and environmental factors.

- Para 20, page 18. The Authority is the regulator of gas and electricity markets in England, Scotland and Wales. It takes its regulatory decisions independently and within its regulatory powers it is free to decide on the most appropriate regulatory approach to a particular issue.
- Para 22 and 23, page 18 the draft SPS notes that GEMA “must carry out its functions in the manner **which it considers best** calculated to further **the principal objective**”, i.e. protecting interests of existing and future consumers, whilst also ensuring that all reasonable demands for energy can be met, that licencees can finance their activities, that sustainable development can be achieved and that the interests of variously defined vulnerable individuals are taken into account.
- Para 24, page 18 subject to these duties, the Authority is required to carry out its functions in the manner which is best calculated, amongst other aims, to secure a diverse and viable long-term energy supply.
- Para 28, page 20 the authority should carry out its regulatory functions in the manner best calculated to further the delivery of the following policy outcomes including secure low carbon energy is delivered at least cost to consumers

In addition, the strategic priorities emphasise the UK’s intention to “play a leading role in efforts to secure international action to reduce greenhouse gas emissions and tackle climate change” but neglects the UK’s legal requirements to reduce its own emissions, potentially unilaterally. This is a serious omission and should be added to the list of strategic priorities.

There also seems to be some inconsistency between the statement in para 22, p 18 that: *“The Authority’s principal objective is to protect the interests of existing and future consumers. The Authority must consider whether it is appropriate to do so by promoting effective competition or by other means”* and the requirement in para 28, page 20 that *“The Authority must in discharging its principal objective duty carry out its regulatory functions in the manner best calculated to further the delivery of...a competitive GB and EU energy market framework.”* One statement seems to require the Authority to develop a competitive market, the other seems to leave it to the Authority to decide whether this is appropriate.

The draft SPS therefore follows the approach of earlier communication between government and the regulator in that it lists a number of duties and aims, while not providing any prioritisation, nor any guidance on how trade-offs should be handled where they exist between duties and aims.

Political Decisions Should be Taken by Politicians

In our view the SPS leaves a number of essentially political decisions (not least because different technological pathways for decarbonisation and different timescales for decarbonisation have major distributional consequences for British society) in the hands of the regulator, whereas they should be taken by politicians. We note that the House of Lords 2007 report on economic regulators (p 72) argued that: *“Government will need to be careful to ensure that Ofgem is not sent mixed messages. Government must be explicit in the political decisions it makes and in the consequent guidance it issues to regulators.”*

It may, of course, be impossible to completely remove political decision making from the hands of the regulator, but at present the line is drawn in the wrong place, and the draft SPS does not substantially change this from the past Guidance Notes. This is because there is a fundamental

tension in the role of an ‘independent’ regulator. Independence and ‘having regard to’ inevitably means that many decisions taken by the Regulator will be of a political nature. So, for example, the recent CMA inquiry can be seen as a response to ongoing political concern about rising fuel prices and the profits of the Big Six. A specific example in the SPS of what we are saying relates to one part of one of the three strategic priorities that Ofgem is meant to be dealing with and discussed in the SPS related to ‘Helping households and businesses take control of their energy bills and keep their costs down’ (page 15). It is not just that Ofgem is not delivering a transparent and competitive market (para 7), hence the CMA inquiry, but there is no explanation of how the Government thinks Ofgem should do this, or how it should make the trade-offs both within and between the different strategic priorities and this area. The same is the case for all other paragraphs 8-12.

This fundamental tension is discussed in the next section but this SPS should have spelt out in far greater detail what the Government wanted in terms of an energy system capable of meeting its objectives.

Question 2: Does the draft SPS clearly set out the main roles and responsibilities of those involved in delivering policy outcomes?

Again, as with the question above our answer is: No, the draft SPS does not clearly set out the main roles and responsibilities of those involved in delivering policy outcomes. This question has significant overlaps with the question above, and our answer above should be taken into consideration here.

While the process of requiring Ofgem to publish its strategy for implementing the SPS and its performance in meeting the policy outcomes is sensible, there is no indication of how these reports will be evaluated, or the process by which Ofgem’s own performance can be evaluated, or could be improved depending on its performance. So, while the SPS may clarify lines of accountability, there is no real improvement in how Ofgem’s performance will be evaluated. The lack of performance criteria applies both to DECC’s oversight of Ofgem, but also to the broader public. If the Government wants Ofgem to take responsibility for certain outcomes then the SPS has to list them explicitly – which it does not do – and clarify what is expected in the annual performance reports from Ofgem; what the responsibility is for Ofgem to ensure certain outcomes; and if Ofgem does not fulfil its responsibilities, what the penalty would be. Overall it is not clear that the requirement for Ofgem to publish its strategy for implementing the SPS and reporting on performance creates a strong incentive for it to ensure a movement towards a sustainable, secure and affordable energy system.

In our view, the Draft SPS is therefore not making clear what Ofgem should or should not do – it is too ambiguous and leaves too much discretion to Ofgem. However, we would argue that the role of the regulator in implementing Government policy should be significantly changed (see below Section 3).

Best Practice Policy

There are several regulatory models in Europe, and elsewhere in the world, all wrestling with problems of how to regulate in an uncertain environment which Ofgem could have learned from. It seems that Ofgem has done little to keep in touch with the reality of surging technological change and energy market upheavals happening elsewhere, particularly in Europe but also America. However, the SPS does not give any guidance. The SPS should make clear that Ofgem is expected to

remain up to date about changes in technologies, costs, markets and services occurring in energy systems globally.

Clearer aims, goals and a Mission Statement

Finally, a much more clearly defined set of aims for Ofgem, including a vision and mission statement which sets out the spirit of what Ofgem should be achieving would be more helpful in creating a clear understanding of their role. Again this is discussed in the next section

Question 3: Does the draft SPS set out the right set of policy outcomes which reflect the Government's strategic priorities and policy goals and which Ofgem has a role in delivering or helping to deliver?

The development of more sustainable energy systems to 2050 and beyond will require long term strategic thinking from both Government and Ofgem because of the long lived nature of energy assets. While this requirement is reflected to an extent in the policy outcomes listed for energy network infrastructure, it is completely lacking in the section on UK and EU market frameworks.

This short term approach is particularly apparent in relation to the delivery of low carbon energy ("*secure low carbon energy is delivered at least cost to consumers*"). If the UK is to shift to more sustainable (rather than just low carbon) energy systems, the regulator will need to ensure that the design of the electricity market does not constrain or penalise new technologies or new ways of doing things. This may entail costs in the short term, while delivering lower cost, more secure energy in the longer. However, by framing market outcomes purely as immediate or short term goals, the SPS is precluding this, and underplaying Ofgem's principle objective of protecting the interests of current and future consumers. In addition, the phrase "at least cost to consumers" (p20) is not consistent with the strategic priority set out in paragraph 8, that prices should be affordable. Least cost would require only the cheapest energy options to be delivered, while affordable does at least allow some leeway to encourage the emergence of new technologies or practices which may be more costly in the short term, but would not place undue financial pressures on consumers.

In contrast, the network infrastructure section incorporates some provision for balancing current and future needs. However, given the potential shift in types and location of generation as a result of increasing levels of renewables, the policy outcomes should also include a reference to flexibility to ensure that changes in network infrastructure in the short term do not necessarily constrain the development of electricity networks which are geared predominantly to reflect centralised generation and the transmission of power over long distances. The policy outcomes for network infrastructure should also include statement that barriers to the connection and deployment of new technologies will be removed. Lastly, the SPS should reflect the fact that it is not just network infrastructure which should be considered by Ofgem, but also the *services* that the network infrastructure supplies – in other words, how the infrastructure is provided and used.

Other Comments on Draft

'Independent' Regulation

The SPS has been written on the assumption that the Regulator and the Regulatory Body remain central to the energy system. We do not consider this to be the case, as we discuss below. But even if this were accepted, then an improvement on the Draft SPS might be that the Duties and SPS of the

current model of Regulator be augmented by (1) a legally based but more nuanced web of guidance in addition to the SRS and Duties by also including a Vision and mission statements, goals and aims which more clearly set out the desired energy outcomes, including the role of energy within society; and then (2) the individual, CEO type regulator with his/her part time Board as now (GEMA) be replaced by a governance system more like a US Public Utility Commission, which has multiple full-time members who apply for the positions.

We would argue that what is needed is a new regulatory and institutional model. This model might be made up of a new set of institutions where the Regulator and the Regulatory Body are no longer the big, central institution that Ofgem currently fulfils but one where the regulatory functions are broken up and modified so that it becomes more decentralized, made up of more institutions with focused roles, more responsive and flexible to the priority goals and needs of energy policy, and that the placing of responsibility is clearer. Thus one, more decentralized regulatory and institutional model might be for example: (1) the Regulator becomes a narrower, smaller economic analysis type agency as in Denmark; (2) a State Owned, not for profit system operator like Energinet in Denmark which has responsibility for the technical transformation to a low carbon energy system; (3) the market monitoring part of Ofgem is turned into an independent market monitor to ensure transparency (and publication) of market pricing; (4) that markets and the system operator work more closely together to better enable integration of operation, including the demand side, storage, heat, interconnection, electric vehicles etc; (5) another institution [ie a small Energy Agency ; or Office of Carbon Responsibility analogous to the OBR; or Energy Board], should be set up so that there is a body which is responsible for overseeing the transformation undertaken by the system operator, as well as the security and affordability of the system. In this sense, this last body might have overall responsibility, but each of the other actors also have responsibility for different areas, thereby enabling a move away from the concentration of influence in a few places. Whatever final form might be deemed appropriate, as a fundamental principle, the economic regulator should not be both setting the regulatory framework and being responsible for delivering a transformation in the system.

The wording of a vision and mission statement, the choice of the aims, the choice of the regulatory model etc is, of course, an inherently political process which needs to be recognised as such and preferably should be undertaken in as broad a consensus, cross-party manner to give it some longevity. It seems to us that the SPS should more clearly set out its vision for an energy system going into the future. This might be a Vision for greater innovation of practice within the energy system in terms of new entrants, types of business models, new services, new technologies, new customer relationships which together would lead to greater efficiency of operation; greater liquidity of markets; reduced fuel poor numbers and so on. The Mission Statement would be a shortened version of this Vision but it seems to us that the SPS has to more clearly show the direction of travel and move away from a legalistic approach of 'must have regard to' towards one which is much more about the spirit of intention.

The writing of the SPS would continue as the responsibility of Government; it would be the new overseeing institution which would ensure it was fulfilled. But the writing of the SPS could become a vehicle for far greater consensus and transparency of energy policy.

This suggestion of a new institutional and regulatory arrangement is of course a significant change and not to be undertaken lightly without extensive consultation. However, a strategic framework and an independent regulator has an inherent tension. An SPS which does not also spell out broader institutional change, the time lines of decarbonisation, and how the regulator fits with this, is not confronting the current and future needs of the energy system or capable of meeting energy policy objectives.

Bringing Heat, Transport and Electricity Together

Ofgem is only responsible for the economic regulation of the gas and electricity sectors. In the context of energy security, energy price rises and climate change it would be helpful to the long term strategic development of the energy sector as a whole (ie electricity, heat and transport) if there were some indication of how the role of Ofgem may fit with that. This is particularly important given the emergence of heat as an important option for delivering climate goals and the synergies that heat production can have with electricity production.

Knowledge Gathering

Energy is in a time of huge change and Ofgem needs to keep up with technological change, operational possibilities, costs, new business models, customer preferences and so on. The SPS should make this clear and it should be one of the criteria against which Ofgem's performance could be evaluated. Ofgem like all bodies associated with Government are constantly under pressure to cut costs. SPS needs to highlight the areas that are vital to enable strategic long term planning.

What an SPS should contain

An SPS should clearly set out the priorities of Government in far more detail and in a more structured and prioritised way than the current SPS does. It should also discuss how to make trade-offs between those priorities. The SPS should also be embedded within an institutional setting appropriate for a secure and equitable energy transformation. Explaining how to bridge policy and outcomes requires more than a legalistic document. It has to be a powerful description of the vision the Government has for its future energy system, and how it sits within society.

The Draft SPS has scarcely moved on from the Social and Environmental Guidance. It has asked no further questions of the institutional needs of the transformation to a sustainable, secure and affordable energy system; nor has it asked questions of the role of the Regulator, of utility companies or of customers. Nor has it asked questions of Ofgem's responsibility to wider society, beyond customers. It has scarcely made a nod towards the enormous changes going on within the energy system.

In this sense, the SRS is a disappointment. It reads like a compromise between Government and Ofgem. It needs to move beyond this into a realm of transparency and greater stakeholder involvement.