



November 1998

**Ofgas' Response to the
Government's Public Consultation
Paper on The Future of Gas and
Electricity Regulation**

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Introduction

Ofgas welcomes the government's review of utility regulation and the opportunity to respond to the DTI's public consultation on the future of gas and electricity regulation.

Many of the proposals set out in the consultation paper involve bringing the electricity regulatory regime more in line with that of gas, better to promote competition and protect consumers. Ofgas generally supports this approach and we look forward to bringing our experience of gas regulation to bear in future discussions, as detailed provisions to implement this general approach are devised.

PROPOSAL 1.1: The Government invites views on how the gas and electricity markets might look after further developments over the coming period, say in five to seven years.

Radical changes have taken place or are taking place in the former utility industries. In the case of gas, the structure of the industry has fundamentally altered over recent years. Competition has now been introduced throughout Great Britain for domestic consumers, following its earlier successful introduction to the industrial and commercial sector. More changes are underway as additional services, such as the provision and reading of meters, are opened to competition.

In Ofgas' view these changes have important implications for the future of regulation. The traditional emphasis on comprehensive regulation of integrated monopolies, typified by price control, will change to a regulatory role of securing and policing effective competition in the interests of consumers. Such a regulatory role will typically not include price control.

The traditional type of regulation will continue only where there remain monopoly or dominant elements in the regulated industries. As the task of securing effective competition gathers momentum, such elements can be expected to decrease.

Ofgas considers that the current utility review including of gas and electricity regulation should aim to provide a future framework for regulation to match these developments. Ofgas' response to the proposals in the consultation paper on the future of gas and electricity regulation has been formulated with this aim in mind.

Ofgas' views on the key proposals in the consultation paper are given below.

Consistency Between Gas and Electricity Regulation

PROPOSAL 2.1: The Government proposes to provide in legislation for the appointment by the Secretary of State of a combined energy regulator (in the shape of an executive board) in place of the Directors General of Electricity and Gas Supply.

Ofgas agrees that with the convergence of the gas and electricity markets it is sensible to bring together the two regulatory regimes. That process has already begun with the appointment from 1 January 1999 of the current Director General of Gas Supply to the position of Director General of Electricity Supply.

The experience of the office of the Northern Ireland Energy Regulator indicates that in principle it is possible to envisage the regulation of the gas and electricity industries continuing to be undertaken on the basis of two separate Acts, with a single person holding both the posts of both Director General of Gas Supply and Director General of Electricity Supply. However Ofgas considers this is a less satisfactory approach than to regulate the gas and electricity industries under a formal structure that has been set up on a unified legislative basis.

Ofgas notes that it has already proved necessary to take powers under secondary legislation to provide the necessary legal gateways to enable the exchange of information between the members of staff in the two organisations.

PROPOSAL 2.2: The Government proposes that the regulator should have a power to take a broad view in the exercise of his duties across both electricity and gas markets. This power would have to be exercised reasonably, in accordance with normal provisions of administrative law. Views are sought on whether any additional safeguards on the exercise of such a power might be desirable.

Ofgas agrees that over the next few years the gas and electricity markets will experience increasing convergence not only in supply (where we already have some experience in the introduction of “dual fuel” products) but also in areas such as the wholesale energy market where electricity generators are making decisions about gas use which impact on both the availability and cost of both electricity and gas in the marketplace. It will be important therefore for the regulator to have sufficiently flexible powers to regulate effectively in both markets.

PROPOSAL 2.3: The Government believes that the new energy regulator should operate under one combined set of duties. It invites views on whether there are certain distinctions between the duties which should be retained.

Ofgas supports the Government’s view that the duties of the regulator should be aligned wherever possible. However, in Ofgas’ view it is likely that the existing duty on the Director General of Electricity Supply to take into account the protection of rural customers’ interests with regard to price and the other terms

of supply will become obsolete with the introduction of the new primary duty to protect consumers. Nor is it clear that there is a continuing need for the duty to promote research and development by electricity licence holders, since it is likely that this area of activity would be covered by a combination of the regulator's other duties.

In the gas industry responsibility for health and safety rests primarily with the Health and Safety Executive (HSE). Under the terms of section 4 A of the Gas Act the regulator must have regard to safety issues in the exercise of his functions and must consult with and enter into a Memorandum of Understanding with the HSE. A similar arrangement may be appropriate for electricity.

PROPOSAL 2.4: The Government does not propose to move from separate gas and electricity licences to combined energy licences.

Ofgas supports the Government in its view that there is little merit in the proposition that the licensing provisions should be aligned to create "energy" licences. Although there will be a number of companies which seek to be licensed to supply both gas and electricity, it will not always be the case, and there may be a number of businesses which will wish to supply only gas or electricity.

Although it is possible to contemplate a situation in which a supplier could be a holder of an "energy" licence but licensed to supply, for example, only industrial and commercial gas customers, such a concept is likely to cause confusion in the minds of customers and should be avoided if possible. Similarly, Ofgas would support any proposals by the Government to take the opportunity to clarify the licensing arrangements between gas suppliers which are granted a domestic supply licence and those licensed to supply only the industrial and commercial market, which are subject to a narrower range of the standard licence conditions.

PROPOSAL 2.5: The Government proposes that there should be a system of standard licence conditions for electricity (following the gas model). It invites views on whether or not the power to grant individual licence exemptions should be continued, and on the abolition of the Secretary of State's reserve power to grant electricity licences.

In Ofgas' view it would be sensible to standardise as far as possible, and so far as appropriate, the standard conditions of gas and electricity licences both within each of the industries and across the two industries. The obvious candidates for standardisation are the licence conditions dealing with the social obligations of domestic suppliers. For there to be different social obligations in the gas and electricity industries would seem to be hard to justify.

Ofgas supports the Government's view that in future the regulator is the appropriate person to grant licences in both the gas and electricity markets. There is currently no role for the Secretary of State to grant gas licences and

unless there is good reason for divergence, the positions in gas and electricity should be consistent.

At the moment the power to grant exemptions lies with the Secretary of State. It is a useful power that can be used individually as in the case of the recent exemptions for the Irish and Continental gas interconnectors, or on a class basis as it is currently expected to be used in relation to gas storage. Ofgas sees no reason to alter this power and would suggest that an equivalent power in relation to electricity (if it does not already exist) would be useful.

PROPOSAL 2.6: The Government supports the principle of collective licence modifications for certain licence conditions. It invites views:

- i) as to how this can best be achieved to ensure that the licensing regime can evolve to meet the changing needs of the market, while retaining fairness and transparency for market participants;**
- ii) on the models for collective licence modification set out in this document, and – in the case of the “enhanced gas model” – the percentages which should be applied to determine the level of the “blocking minority”;**
- iii) on whether different procedures might apply to different types of licence and, if so, what they might be.**

Under the terms of the Gas Act 1995 the standard conditions of the licences to be given to each of the public gas transporters, shippers and suppliers were determined by the Government. In addition, special licence conditions were imposed on Transco and British Gas Trading. The basis for the amendment of the standard conditions of each type of licence, was set out in primary legislation and requires agreement to the proposed amendments by the overwhelming majority of licensees in any category of licence, counted by both number of licensees and by volume of gas conveyed, shipped or supplied.

Ofgas understands that the formulation of two tests was intended to provide the regulatory certainty to enable companies to make the necessary investment to enter the market. It was also intended to prevent the regulator from imposing damaging licence conditions on a dominant company, through the vehicle of proposing modifications to the standard conditions of a class of licence, the effect of which primarily impacted on the dominant company.

By contrast, Ofgas has a fundamental concern with the principle of the current arrangements under which a licence modification proposed by the regulator, and supported by all other licensees affected, could nevertheless be vetoed by the dominant licensee. In such circumstances, once the modification was rejected, the Gas Act provides for the regulator to take the decision to refer the entire class of licensee to the MMC for resolution. This procedure is inevitably time-consuming and in relation to matters affecting the competitive market, the

resulting delay could have a serious detrimental implications. The procedure therefore provides a potential route for anti-competitive behaviour by a dominant licensee.

In Ofgas' experience there are two major deficiencies with the current arrangements. The first relates to the definition of "relevant activities" applied to the volumetric test in section 23 of the Gas Act and is an issue encountered by Ofgas when attempting to introduce Standard Condition 14A into the standard conditions of gas supply licences. The proposed condition was intended only to apply to activities of licensees in relation to domestic customers (ie those consuming 2500 or less therms per annum). However in Ofgas' view it was not clear whether the consent of licensees supplying 90% by volume of all gas supplied was required or whether it was sufficient to obtain the consent of licensees supplying 90% by volume of gas supplied to domestic customers.

In the event, consent was given by licensees supplying more than 90% of all gas supplied in both the domestic and industrial and commercial markets, and the modification to the standard conditions of supply licences was made, but Ofgas is not confident that it always could obtain such support. Ofgas therefore believes that, if a proposed modification would apply only to the standard conditions of licences of a particular group of licensees, then it should be necessary for the regulator only to seek the consent of that group of licensees.

Ofgas' second concern relates to the fact that under the terms of the Gas Act, it is necessary for the regulator to obtain the positive consent of licensees to a proposed modification, even though, as in the case of Standard Condition 14A, it may have no impact on licensees who do not supply the domestic market. In Ofgas' view it would be more appropriate for silence to be taken as consent and for those who object to the proposal to make their objections known. If this course is to be adopted then it will be important to ensure that the regulator can demonstrate that he has taken reasonable measures to bring the proposed modification to the attention of those affected and that full and proper consultation has been put in place.

Ofgas therefore supports the approach set out in paragraph 2.22 of the Consultation Paper, and suggests that an appropriate level to set before a proposed modification was rejected might be 15%. In Ofgas' view the "qualitative model" may not provide sufficient regulatory certainty for licensees, and potential licensees, to the ultimate detriment of consumers.

Ofgas understands the Government's concern in relation to the possible effect of a volumetric test when applied to proposed amendments of the standard conditions of domestic supply licences. In Ofgas' view, however, the application of a test relating to the number of premises supplied by domestic licensed suppliers rather than volumes of gas or electricity supplied would in practice be unlikely to affect the outcome.

PROPOSAL 2.7: The Government invites views on whether it would be of benefit to introduce mechanisms for adapting types of licences, such as any or all of those described above, without the need to resort to primary legislation.

Ofgas welcomes the Government's proposition that a mechanism should be introduced to allow for the continuing regulation of activities where the licensee has a de facto monopoly and when they are unbundled from the monopoly provider. For example Ofgas' recent experience in the case of the sale of Central Quantum Office from BGT, leads it to the view that such "special licences" will be important for the development of competition. In such cases, the regulatory regime should continue to apply so long as the incumbent is in a dominant position. Ofgas envisages that it should be feasible to introduce a sunset provision similar to that set out in standard condition 14A of the gas suppliers licences. This allows the condition to cease to have effect on a specified date, unless the Director General considers that the development of competition is such as to require the continuation of any part of the condition, in which case it may be extended, following appropriate consultation.

Although section 23(10) of the Gas Act makes provision for the regulator to remove activities from regulatory regime, Ofgas welcomes the Government's proposal to introduce a mechanism for changes in the types of licences to be made through secondary legislation. In Ofgas' view this will allow the regulator to respond more flexibly to the changing needs of the market.

PROPOSAL 2.8: The Government invites views on whether some of the activities currently undertaken by shippers should instead be undertaken by suppliers and/or customers; and/or whether gas shippers' licences might be abolished altogether.

Ofgas supports the proposition that it may be possible to remove the licensing of gas shippers with their activities being undertaken by others including suppliers and customers. Following representations from industrial and commercial customers, Ofgas has published a Consultation Document which addresses a number of these issues.¹ The document proposes alternative arrangements, which in certain cases would allow customers to make connection arrangements directly with Transco, and align the position in the gas market more closely with the arrangements for connection agreements in the electricity market.

PROPOSAL 2.9: The Government invites views on the proposal to bring the two regimes into alignment either by abolishing the ability to assign gas licences or by introducing it to electricity licences.

The ability to assign licences is of value to regulated businesses. When they undertake restructuring it is a more streamlined and more certain means of disposing of parts of their business than having to go through the process of

¹ 'Customer/Transco Issues in the Industrial and Commercial Gas Market - A Consultation Document', Ofgas, October 1998.

applying for a new licence. Assignment is a facility that has been used in gas and is a feature of standard condition of shippers and suppliers licences. Ofgas would like to see the ability to assign licences retained in the new regime.

Separation of Supply and Distribution of Electricity

PROPOSAL 3.1: The Government does not propose, in legislating for separate licences for supply and distribution, to require the supply and distribution businesses to be held separately. Instead, the Government is attracted to the proposal that the supply and distribution businesses should be required to be held in separate legal entities (which could be in common ownership). It nevertheless notes that there may be issues involved with this proposal – in particular with the transfer schemes needed to effect the separation into two companies of a PES’s assets and liabilities. The Government invites views on this proposal, in particular on any difficulties involved in such a separation and how they might be mitigated, and on the associated costs.

PROPOSAL 3.2: The Government accepts the logic behind operational separation, and recognises that the detailed aspects are a matter for the regulator to pursue.

PROPOSAL 3.3: The Government believes, as in England and Wales, that steps should be taken in Scotland to improve the transparency and effectiveness of the regulatory regime and provide for greater competition. It therefore invites views on the proposals to:

- i) require the generation, transmission, distribution and supply activities of the integrated Scottish companies to be carried on by separate Companies Act companies;**
- ii) require independent operation of the transmission activities of the integrated companies; and**
- iii) to remove the qualification of the duty on transmission licence-holders to facilitate competition in the supply and generation of electricity.**

Ofgas welcomes the Government’s proposals for the effective separation of supply and distribution in electricity. Such a separation is already in place in gas. In Ofgas’ view, separation of distribution into a separate legal entity is essential for the successful introduction and development of competition. With the convergence of the gas and electricity markets it will become increasingly important for companies supplying in both markets to have the confidence that they are competing on equal terms, which is not possible while distribution is undertaken by a company which also undertakes supply activity.

In the case of the British Gas, a transfer scheme apportioning assets and liabilities was used successfully and therefore Ofgas does not believe that the need for transfer schemes to be put in place to apportion the assets and liabilities

of the PES companies will prove to be an insurmountable obstacle to progress in this area.

Changes Consequent on Separate Electricity Distribution and Supply Licences

PROPOSAL 4.1: The Government considers that all suppliers should be placed on an equal footing in the competitive electricity supply market, on the basis of a requirement to offer contract terms on request. It invites views on the best way to achieve this, while ensuring that all groups of customers have access to electricity supply on reasonable terms.

PROPOSAL 4.2: The Government proposes to extend to electricity the provision for deemed contracts that exists in gas. It invites views on the operation of this scheme, and on any threshold to the size of contract above which it might not apply.

PROPOSAL 4.3: The Government proposes that a mechanism be put in place to ensure that there is a supplier of last resort. It invites views on which mechanism would be best, and which customers should be protected by such a mechanism.

PROPOSAL 4.4: The Government invites views on the definition, scope, rights and obligations of the separate activity of electricity distribution.

PROPOSAL 4.5: The Government invites views on the changes that will be necessary to adapt the electricity legislation as a consequence of separate licensing of supply and distribution.

Ofgas supports the Government's proposals.

Metering

PROPOSAL 5.1: The Government supports the introduction of full competition in meter reading and meter provision. It invites views as to how this can best be achieved to ensure that its benefits accrue to all consumers including the disadvantaged. It further invites views on any necessary restructuring of gas and electricity legislation to reflect the development of competition and on the desirability of introducing separate licensing of metering.

Ofgas welcomes the Government's support for the introduction of full competition in meter reading and meter provision. Ofgas has recently published its initial proposals for developing conditions which will help to secure effective competition in metering for the benefit of consumers.² Ofgas proposes three

² 'Securing effective Competition in Gas Metering and Meter Reading services - The Director General's initial proposals', Ofgas, October 1998.

fundamental measures for the development of effective competition in metering and meter reading:

- ◆ splitting Transco's existing price control into three parts covering transportation, metering and meter reading. This will help to ensure that Transco's charges are more transparent and cost reflective;
- ◆ physically, financially and informationally separating the three businesses. This will help to ensure that Transco does not give preference to its own metering and meter reading businesses over competitors, when using Transco's administrative services; and
- ◆ developing new operational processes to support the development of competitive procurement of services. Processes do not exist, in most cases (except non-daily meter reading), to allow shippers, suppliers or customers to procure services independently of Transco.

Ofgas believes that these proposals will ensure that the benefits accrue to all consumers, and that the disadvantaged will particularly benefit through increased innovation in metering technologies and associated services.

Ofgas does not consider that there is the need for fundamental restructuring of gas legislation to reflect the development of competition in metering and are not convinced of the need to introduce the separate licensing of meter service providers.