

Rec'd 13/9/04

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Dear Michael

**Draft guidance on impact assessments (172/04)**

I write with comments on the above document and welcome the opportunity to provide input to the developing framework of Regulatory Impact Assessments (RIAs) that the Authority is now obliged to undertake as a result of the provisions of the Sustainable Energy Act 2003. I set out our views below, including comments on the RIAs that Ofgem has carried out so far and listed in Appendix 2 of the document.

**Use and Timing of RIAs**

We welcome the attention that Ofgem is paying to the production and development of RIAs, including the production of this draft guidance document. We agree with Ofgem that impact assessment should be an integral part of policy development and that it will contribute towards Ofgem being able to demonstrate that it is carrying out its duties with regard to the principles of best regulatory practice, as now required by the Energy Act 2004.

The new statutory requirement for the production of RIAs relates to situations in which the Authority proposes to carry out some regulatory "action" for the purposes of carrying out its statutory functions. However, we believe that it will generally be a helpful discipline within Ofgem if RIAs are considered as early as possible in the process of policy formulation, so that options where costs clearly outweigh benefits are abandoned at an early stage. We therefore also welcome and encourage Ofgem's intention to undertake "non-statutory" RIAs in circumstances where this will help to inform the most cost-effective development of policy options. If used appropriately, such RIAs may reduce the overall burden of consultation on the industry by focussing subsequent consultation on options with a more favourable balance of costs and benefits. It will also be beneficial for Ofgem to consult informally on policy

development, as proposed, with a view to stimulating debate and establishing whether a full RIA approach is required. In this regard, however, our comments below on timescales are relevant.

### **Definition of “important”**

We recognise that the decision on whether a policy proposal is “important” (and therefore becomes eligible for a statutory RIA) rests with the Authority on a case by case basis, subject to the definition set out in the Utilities Act. However, it is helpful that Ofgem has set out some examples in section 4 of the document, of how a particular proposal might be assessed as “important” enough to merit the production of an RIA.

We have two suggestions for clarifying this aspect of RIA production.

Firstly, at paragraph 4.7, the term “significant impact” is discussed and we consider that this should be further amplified in the guidelines. Our proposal would be that a significant impact on an industry participant is one that appears likely to involve a cost in the region of £100,000, a change to its competitive position and/or could increase perceptions of regulatory risk in the sector.

Secondly, in the context of the “effects on the environment”, this is an area where the Authority receives guidance from the Secretary of State. Therefore, in our view, a proposal should be considered important if it could be viewed as potentially having implications for stated government policy on the environment.

### **Content of RIA**

At paragraph 6.4, Ofgem lists the general headings that it expects to use in an RIA, where appropriate. We agree that the items on this list are reasonable and in particular, support the “do nothing” option as the usual base case against which to assess other options. Options considered should also include industry action or self-regulation, where appropriate.

We suggest two additions to the list. Firstly, we believe the impact on customers should be given the same consideration as “impacts on competition”. Secondly, it will be important, within the section on costs and benefits, for investors’ perception of regulatory risk to be explicitly considered as this affects the cost of capital for regulated businesses and hence the eventual cost to customers. The types of regulatory action which increase the perception of regulatory risk include, for example, reviews involving uncertainty and step-change in the basic commercial liabilities of industry participants, particularly in relation to the development of use of system and connection charge structures. Another significant potential cause of increased regulatory risk is any change to calculations underlying the economic value of regulated businesses, for example the calculation of regulatory asset value or major changes to the incentive structure facing regulated network businesses.

In the introductory section of the document, Ofgem discusses qualitative and quantitative assessments, suggesting that there will always be a mixture of the two types of assessment in an RIA. Whilst we accept this point in general, it should not be used as a reason to avoid doing a proper quantitative assessment in situations where major reform is proposed. There is

a substantial indirect cost (in digesting and responding to consultations, attending workgroups, disseminating information internally about the change etc) for industry participants when major reform in industry practice is proposed, as well as the obvious direct costs of system changes etc. We regard it as essential that RIAs in these cases prove a quantitative benefit before regulatory action proceeds. In our view, this has not been the case in some of the RIAs produced to date, such as the RIA on off-take arrangements in relation to potential sale of gas distribution networks or the proposals for exit reform in gas transmission charging, which was launched without the benefit of an RIA. The recent inclusion of this latter reform within the RIA for off-take arrangements has, in our view, provided an inadequate and notably unquantified attempt at justification for this major project for reform.

### **Timescales**

We welcome Ofgem's commitment to a minimum 6 week consultation period from January 2005. We understand that a shorter timescale is sometimes required where the consultation timetable is dictated by other bodies, for example in merger cases where Ofgem consults in order to advise the Office of Fair Trading. It may also be necessary to consult over a shorter timescale where the issue is genuinely urgent, but this situation should be rare.

On the other hand, there are many circumstances where a longer consultation period than the minimum would be helpful. These include all the circumstances noted by Ofgem at paragraph 5.7. In this context, we note that the Cabinet Office Code of Practice on Consultation recommends a minimum consultation period of 12 weeks, with longer periods where necessary to cover the sort of circumstances referred to paragraph 5.7. This lends weight to the proposal for longer consultation periods than the new minimum in some circumstances.

### **Industry Codes**

We agree with the proposal in section 7 of the document that Ofgem's decisions on modifications of gas and electricity codes should also be covered by RIAs. The same tests as are proposed for deciding whether other regulatory actions are "important", as discussed above, should also apply to code modification decisions. We note that Ofgem intend to put provisional assessments of whether modification proposals are "important" on its website. We would support this, but would also advocate that there is automatic notification of these via the email distribution list, as for other publications.

In our view, the use of "urgent" status for industry code modifications is used too often and too lightly at present. We would be disappointed if important modifications were frequently not covered by an RIA due to the use of "urgent" status. We suggest that an abbreviated form of RIA is developed for "urgent" modifications, if these continue to be brought forward as frequently as has been the case up to now.

### **RIA for existing projects**

We note that the House of Lords Select Committee on the Constitution in its recent report on the accountability of regulation recommends that RIAs be conducted retrospectively as well as in advance of proposals. We have advocated for some time that retrospective RIAs are carried out for major projects, which are proceeding without the benefit of any such initial assessment. Now that the requirement for Ofgem to produce RIAs has been put on a statutory

footing, it would seem even more appropriate for major regulatory projects initiated before 30 December 2003 to be subject to an RIA, so that the Authority can be assured that all its resources are allocated appropriately and cost-effectively.

### **Best Practice on Consultation**

We have mentioned above, the Cabinet Code of practice on Consultation in relation to the timescales for consultation, mentioned at section 5 of the document. Another element of the Cabinet Office Code relates to the monitoring of the effectiveness of consultation, including through the use of a "designated consultation co-ordinator". In practice, we have noted that government and some other regulatory bodies routinely provide, within any consultation document, a named contact to whom queries and complaints about the individual consultation process can be directed. The contact is normally in a different part of the organisation from that leading the particular consultation. We would recommend that Ofgem consider inviting such feedback within individual consultations and suggest that the "Corporate Affairs" directorate might be best placed to provide this process monitoring function.

### **Comments on RIAs**

The majority of RIAs that we have seen in the last few months have been well laid out under relevant headings. An area that we consider could be improved is that of the quantification of costs and benefits. In our view, the authority and purpose of an RIA is undermined if there is little in the way of objective cost and benefit information, and similarly if any costs that are presented appear to be little more than perceptions without adequate justification.

I hope these comments are helpful.

Yours sincerely

*Allen M Wilson*

*PP* . Rob McDonald  
**Director of Regulation**