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*Promoting choice and
value for all customers*

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Dear Bernard,

In its request for comments on the Gas and Electricity Markets Authority/Ofgem review, the SDC raised a number of questions about our remit and our approach to our duties. We had a useful session at the beginning of August in which we took Gavin and Clive through this but thought it might be helpful to set it out in writing. Given that we are frequently asked to explain our role in relation to sustainable development, we are, in addition to writing to you, also publishing this letter on our website.

Given our remit, we play an important role in influencing the shape of the future of the gas and electricity networks and, to a lesser extent, markets in Great Britain, which in turn are a major part of the economic and social fabric of the UK. The gas and electricity industries also have a major impact on the environment - through emissions of carbon dioxide and other pollutants, through energy lost in transmitting energy and through the environmental impact of the gas and electricity networks.

Most of the significant actions and policies to make the energy industry more sustainable are not within our direct control. However, we think we have an important role to play, including through influencing the Government and other agencies and we take our contribution to the attainment of the objective very seriously. We now publish a new annual report – the Sustainable Development Report – which sets out a range of simple indicators that assess how sustainable the British energy industries are. We also set out in the report actions we are taking to help make the energy sector more sustainable and actions we think the Government or other agencies should or could take.

Evolution of duties and approach

Our approach to sustainability has evolved over time. This has been driven by a number of factors including: developments in the statutory framework within which we operate (see the “Statutory Framework” below and the annex); the growing scientific evidence base about climate change (which is relevant to how we interpret our principal objective to protect the interests of present and future consumers); shifts in the market and in consumer attitudes

towards sustainability; and the development of Government policy and priorities in response to climate change and sustainable development.

Given our role as an economic regulator, we think that our duties should remain broadly consistent over time to provide a stable basis for the significant capital investment that the energy industries need to maintain secure supplies but also to make them more sustainable. However, we recognise that real and enduring shifts in both public priorities and Government priorities and policies can properly be reflected in changes to our duties.

Some have described our approach as being focused solely on economic regulation or minimising or reducing energy prices. This is a misconception. In the early years there was certainly a strong drive towards making the industries more efficient and reducing costs through effective network regulation and the introduction of competition where appropriate. A consequence of this was reduced prices but this was not at the expense of sustainability. The spur to greater efficiency saw huge reductions in emissions of carbon dioxide and sulphur dioxide as generators closed old, inefficient, coal and oil fired plants and replaced them with new, more efficient, gas fired plants. Effective network regulation led to lower levels of losses and better decisions about where to locate new infrastructure – reducing the need for network investment and the environmental footprint of the networks. The large reduction in prices also benefited the fuel poor.

The Authority's principal objective is the protection of the interests of consumers - both present *and* future - which firmly includes sustainability. The statutory framework – duties, powers and functions – sets the parameters within which we work to meet this objective. The principal objective and the range of duties established in the Utilities Act 2000, enshrine the elements of sustainability: social, economic and environmental considerations. The sustainability duty, introduced in the Energy Act 2004, builds on these.

What difference has this made in practice?

The first and best answer to this question is to look at some recent examples of the actions, decisions and policies which the Authority has progressed. As these examples (listed below) will illustrate, we see our role in relation to sustainable development as a multi-faceted one – one where we are working as an initiator, advisor, facilitator and administrator, as appropriate.

Recent examples of our activities include:

- Setting the electricity distribution price control for 2005-2010. In doing so, we initiated new incentives (distributed generation incentive and Registered Power Zones and the Innovation Funding Incentive for distribution companies to reward generation connections – principally renewables - and to encourage innovation in network development). In addition, we significantly strengthened incentives to reduce distribution losses, partly due to consideration of the carbon benefits of loss reduction, and committed to an additional mechanism to provide funding for selected network undergrounding in areas of outstanding natural beauty.
- At the same time, we have set up a new scheme to reward electricity distribution companies who go beyond their licence obligations in serving more vulnerable consumers in their area, and will be looking at opportunities to tackle barriers to the extension of the gas network into non-gas communities in the future gas distribution control.

- We have initiated work to tackle the barriers to the development of smarter metering and microgeneration to help realise their potential. Here we have shown how we can use our influence as well as our statutory powers. Our call to suppliers to develop simple products and a fair export tariff for customers to avoid the need for regulation has already lead to two suppliers announcing that they will launch products in the near future.
- In distributed generation, we are also initiating, with the DTI, a review of the barriers and incentives to the development of distributed generation.
- As a facilitator we have allowed some £560m of investment in the Scottish transmission system to connect renewable generation in response to growing demand for connections driven by the Government's renewables policies.
- We have published clarificatory guidance on the development of social tariffs and initiatives in the competitive market which have facilitated the growth in suppliers' measures to help fuel poor and vulnerable consumers.
- Through the transmission price control review we will be enabling significant investment to renew gas and electricity networks, to safeguard the quality and reliability of supplies and to connect new generation including renewables. In this package we are also proposing to initiate new incentives to reduce leakage of certain greenhouse gases and to promote innovation.
- We have contributed effectively to the debate on emissions, climate change and carbon reduction and drawn on our expertise to advise on measures to limit carbon as cost effectively as possible. We have advised the Environment Agency and the Government on sulphur dioxide emissions and on implementing the emissions trading scheme. We have also developed innovative proposals, which were set out in our response to the Energy Review, for a carbon contracts scheme to bridge the gap to the next phase of EU ETS (from 2012).
- We administer the Government's environmental schemes (RO, EEC etc) to help facilitate market development.

Our actions, decisions and policies in this area are informed by full and thorough consultation with a wide range of stakeholders, by the views of groups we have created to advise us - such as the Social Action Strategy Review Group (SASRG) and the new microgeneration forum - and, where relevant, by impact assessments which might consider, amongst other things, the environmental, distributional, economic and security of supply effects of policy proposals.

We have also re-organised to respond to the sustainable development agenda:

- We have established a sustainable development committee of the Authority led by Dr Robin Bidwell (a non-executive member of the Authority) which advises the Authority and has driven the development of our first Sustainable Development Report. More broadly the Authority's work is also informed by two key advisory committees –an Environmental Advisory Group (EAG) and the SASRG – which are made up of leading representatives in the energy sector concerned with environmental and social issues.

- At executive level, we have reorganised in response to the growing work on administering the environmental schemes by bringing this under the supervision of our Chief Operating Officer and have moved environmental policy work into the heart of the Markets policy division.
- Sustainable development is in the fabric of the organisation with a wide range of schemes in place to ensure we run our office in as environmentally sympathetic a way as possible. Our retention of ISO 14001 since February 2002 is recognition of this.

The Statutory Framework

We have considered and debated our environmental and sustainability duties and what they mean for us on a number of occasions.

Our thinking has been informed by a wide range of factors, including our interpretation of our duties and views gathered from, for example, our open Authority meeting, regular discussions which the Authority hosts with key stakeholders, consultations and impact assessments and from the EAG and the SASRG.

You have sought to understand how we interpret our duties in this area and it may be helpful in that regard to draw out some principles which have, together with the input described above, helped to shape the Authority's policy decisions as they relate to sustainability.

- The Authority's principal objective is to protect the interests of consumers, both existing and future. The interests of consumers are those as consumers of gas and electricity and not as citizens or members of the public.
- The Authority will consider what the "interests of consumers" are in any particular case. Typically, however, the interests with which the Authority will be most concerned are those relating to the availability, affordability, quality and security of gas and electricity supplies. The concepts of sustainable development have an important role to play, not least because the consumers whose interests the Authority must protect include future consumers. Decisions taken now will have an impact on availability, security and costs of gas and electricity in the future which are inextricably linked with the concept of sustainable development.
- The statutory framework places a clear upper bound - the principal objective - on the actions that the Authority can take in applying its general duties. The framework allows a significant level of discretion within that bound.
- This framework allows the Authority to incorporate social and environmental factors into decisions even where this would involve allocating additional costs, provided always that the decision is justified and is within the framework of the principal objective and other general duties
- When taking decisions involving the allocation of additional costs to consumers, the Authority would consider, where appropriate, whether these decisions would affect all consumers by reference to their consumption or whether it would be more appropriate for the Government to meet these costs through taxation. This position is

supported by the social and environmental guidance to which the Authority also has to have regard. The guidance states that where Government wishes to implement specific social or environmental measures which could have significant financial implications for consumers, or for regulated companies, these will be implemented by Ministers rather than the Authority.

There are limits to our role and in this context it is worth noting what others have had to say about this.

First, the BRTF in that organisation's report on economic regulators and the respective roles of Government and the regulator (2001) said:

"It is probable that regulators will continue to play a role in the delivery of social and environmental objectives. They are well placed to do so as they have the relevant expertise and they work closely with the companies. However, Government must remember that the function of regulators is not to design social or environmental change. Regulators should not be required to create government policy but they can contribute to the solutions to problems."¹

Secondly, the NAO concluded in its report into Ofgem social and environmental programmes, July 2004, that:

"the Government should be cautious about extending the responsibilities of independent regulators such as Ofgem to administer detailed schemes in future if these would conflict with the regulator's principal statutory objective of protecting the interests of consumers."²

Conclusion

Our new Sustainable Development Report aims to pull together all our work under the sustainability umbrella. It also, for the first time, establishes indicators by which we will monitor progress, but recognises that the policy instruments and actions necessary to achieve more sustainable energy solutions are not all within our remit.

We hope that this summary of how we see our remit, together with the Sustainable Development Report itself, will be helpful to the SDC in carrying out its review. If we can be of further help then do let us know.

Yours sincerely

Alistair Buchanan
Chief Executive

¹ 'Economic Regulators', Better Regulation Task Force, July 2001. p.18.

² 'Ofgem - Social Action Plan and Household Energy Efficiency', National Audit Office, 22 July 2004, p.9.

Annex – Legal Framework

1986	Gas Act	Range of social, environmental and economic duties
1989	Electricity Act	Range of social, environmental and economic duties
2000	Utilities Act	Range of social, environmental and economic duties and introduced the requirement for the Authority to have regard to social and environmental guidance issued by the Secretary of State
2000	Ofgem's first social action plan published	
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2002	Social & Environmental Guidance I	
2003	Sustainable Energy Act	Amended the Utilities Act to introduce the requirement for the Authority to undertake impact assessments
2003	White Paper	Fully engaged with four goals
2004	Social & Environmental Guidance II	
2004	Energy Act	Introduced sustainability and better regulation duties
2004/2005	Ofgem's environmental policy statement	
2006	Climate Change & Sustainable Energy Act	Reinforces role in relation to microgeneration
2006	Energy Review	
2006 (November)	Ofgem's first Sustainable Development Report	