

Coherence and stability in the conduct of regulatory policies

Regulatory Policy Institute Conference – 25 April 2014 David Gray, Ofgem Chairman

I became chairman of Ofgem on 1 of October last year: right in the middle of a storm of controversy and criticism about the market, the companies, and us.

Even before I started, the news was not encouraging: stories of the failings of the energy market and the “Big Six” suppliers were everywhere. Consumers were saying that energy costs were unreasonably high, and in a BBC survey nearly 70 per cent said they thought that the sector should be nationalised.

In September, Ed Miliband in his speech to the Labour Party Conference, had pledged that a Labour government would freeze energy prices until the beginning of 2017. Labour said it would abolish Ofgem and replace it with a regulator that would “genuinely be on the customer’s side but also enable the investment we need”.

Around the same time, someone coined the phrase “toothless regulator”. This stuck, and soon found its way into most comment pieces about us. By October, when the Big Six announced their price increases, there was outright hostility towards them – and the market – from consumers, politicians and media.

So it’s difficult to argue that all is well on the UK energy scene. In fact, the sort of comments I’ve seen over the last nine months suggest something has gone horribly wrong – the energy sector has failed, or the energy market has failed, or the regulator has failed. Or perhaps all three.

You see this verdict of failure most obviously in Labour’s proposals – but it’s present more widely, and is unwelcome for a number of reasons:

- It’s bad for consumer confidence in the industry. This is self-perpetuating: the commentary is hostile because consumers have lost faith in the industry – but the hostile comment itself causes a further loss of confidence.
- It’s also bad for investment. The energy sector depends on major long-term investment. That in turn requires a stable regulatory and political environment.

- It's also bad for regulation – and not just Ofgem. If the public thinks that regulators are failing in whatever the public thinks they are meant to achieve, it's bad for the future of independent regulation more generally.

Criticism of the companies – and of the regulator – is not new, but it feels worse than it used to be. Much of the criticism of Ofgem is, I think, unjustified but, rather than launching straight into a defence, I'd like to look at how things have changed in recent years and the way that these changes may have influenced things.

What's changed since 2007?

To start with, prices have risen substantially. Wholesale gas prices, government schemes and network costs have all caused bills to rise, although by far the largest factor has been gas prices.

The increase in gas prices dates to the middle of the last decade, when we moved from being self-sufficient in gas to being a net importer. After a period when UK wholesale gas prices had been low following the break-up of the British Gas purchasing monopoly we became linked to international gas prices, which were both higher and rising.

The pattern is confused by some interesting events along the way, such as the fire at the Rough storage facility in February 2006, which caused a massive spike in prices. But the overall picture is of wholesale gas prices rising from about 20 pence per therm in the early years of the last decade to about 60 pence per therm for the last few years.

The various schemes introduced by government and paid for by energy consumers have also had a considerable effect on prices. This started with the Renewables Obligation but has been expanded by a series of schemes designed to pursue various social and environmental objectives. In total, these now amount to about £90 per customer per year, or about seven per cent of the average dual-fuel bill.

Thirdly, network costs have also risen a little in response to substantially increased capital expenditure requirements. But this is easily the smallest factor of the three.

For consumers, the real problem here is that energy prices have been rising at a time when many other prices haven't and incomes have been flat. As a result, average weekly household expenditure on energy has risen from under three per cent of total expenditure ten years ago to more than 4.5 per cent now.

Not surprisingly, the impact of this has been felt most keenly by low income groups. For the lowest-earning 10 per cent of households, energy expenditure has represented about 10 per cent of total expenditure in recent years. This is in line with the simple definition of fuel poverty.

But we are not in unprecedented territory. Expenditure on energy has not returned to the pre-privatisation level of about six per cent. Moreover, the big price increases actually happened a few years ago. So I don't think the extent of the recent furore can be blamed just on prices.

Our expectations for how companies perform

One obvious problem with domestic energy supply is that the consumer only really notices it when something goes wrong. You don't often hear anyone say they had a really good day of electricity

supply yesterday, or that the gas cooker was working really well last night. But if the power goes off, if bills go up, if suppliers get bills wrong, or if it proves to be frustratingly difficult to switch supplier, you notice it. Problems like this have led to persistent consumer irritation with the energy companies. This has been made worse by a track record of bad marketing practices and problems with the introduction of new systems.

More generally, in the aftermath of the financial crash, which shook consumer confidence in markets, there is a real perception that companies – and markets – delivering an essential service can't be trusted to do it properly. People are more interested in companies' standards of behaviour, and if company performance is not up to scratch, they think someone should do something about it.

And companies haven't performed very well against these expectations. In particular, there have been persistent reports of mis-selling and other failings in customer service. There is a growing level of dissatisfaction with company performance, which you can see in the level of customer complaints. For the Big Six energy companies, complaints have risen by 75 per cent over the last five years.

As a result, Ofgem's enforcement work has increased. There have been more breaches of the rules and we have pursued cases more aggressively. We have also increased the scale of fines we impose and we now have powers to order customer redress measures.

The government's role and Ofgem's trilemma

The third area of change is the role of government. Government has become much more involved in the energy sector – both directly and indirectly through changes to Ofgem's duties. In the 1990s it was broadly happy to leave the regulators to get on with delivering efficiency in networks and introducing competition elsewhere. That changed with the growing importance placed on combatting climate change. Government first introduced the Renewables Obligation and gave Ofgem a duty to contribute to sustainable development. That meant that both Ofgem and the Secretary of State had sustainable development duties, and security of supply duties, as well as the primary duty to consumers – the so-called trilemma.

Recently the government has become more directly involved. Reforms to the generation market encourage renewable and nuclear generation through contracts for difference and encourage flexible conventional plant through the proposed capacity mechanism. But it's not just the UK government that has taken a more active role: the EU is also a much more visible presence, pursuing a strongly pro-competition stance, combined with some quite hands-on activity in the development of network codes.

Ofgem and competition

One of the other things that has changed is Ofgem's role. Along with government's intervention in giving Ofgem new sustainable development duties, there was another change more recently which attracted less attention.

This was the addition of a qualification to Ofgem's primary duty, which is "to protect the interests of consumers, wherever appropriate by promoting effective competition". But before taking steps to improve competition, the Authority must now consider "whether there is any other manner

(whether or not it would promote competition) in which the Authority could carry out those functions which would better protect those interests”.

This wording was introduced in the 2010 Electricity Act – and is therefore not specifically associated with any of the main political parties. The Bill was introduced by the Labour government and passed into law by the coalition. This change has always seemed to me to be a very clear steer away from the use of competition powers – and I’m sure it was meant as such at the time – as an antidote to the perception that Ofgem was obsessed with competition.

I was therefore really surprised, when I came back to Ofgem last year, to find a widespread perception in government and elsewhere that Ofgem wasn’t very good at using its competition powers. Interestingly, most of the people who made that point to me had no idea that government had recently legislated to influence Ofgem away from that approach.

Delivering government schemes

The other big change to Ofgem is the emergence of E-Serve – the part of the business that is responsible for delivering some of the government’s sustainable development schemes. E-Serve has grown extremely quickly in a short space of time and we now have more people employed in E-Serve than in economic regulation. Its activities are sufficiently different from economic regulation that it is possible to maintain a reasonably clear line between Ofgem’s implementation role and the regulatory role. But from an external perspective, some may wonder whether these changes have influenced how Ofgem operates – and, perhaps more importantly, how government views Ofgem.

What’s next for Ofgem?

The various changes I have discussed make the challenge of maintaining coherence and stability in regulatory policy, the theme of this conference, rather more difficult. The rise in prices, the increasing consumer distrust of the energy companies and the energy market, and the government’s increasing intervention in pursuit of policy goals have all complicated the sector landscape. The role of the regulator has changed significantly and one of the major parties is committed to replacing Ofgem with a regulator with “more teeth”. So what should Ofgem do in response to this combination of trends?

Whoever wins the next election I think it’s unrealistic to believe that government is going to back off from direct intervention in the energy sector.

Back in 2007, the idea was that government set the objectives and Ofgem’s role was to balance the three responsibilities (or the trilemma) of sustainability, security of supply and affordability, all in the interests of consumers. But since then, it has become clear that government’s views on the relative importance of the three aspects of this trilemma can change dramatically in response to events. The initial focus was on sustainable development – which was thought to be consistent with security of supply and affordability. This led to the various government schemes to promote renewable generation, help consumers with home insulation and support those in fuel poverty. But recent concerns about security of supply led to the addition of the capacity mechanism to the government’s Electricity Market Reforms. Then, over the past six months, the emphasis on affordability has led to real concerns as to whether the full cost of all these schemes can realistically be imposed on energy consumers.

So, if you accept that government is bound to be involved in balancing the relative priority given to these major policy objectives, it is crucial to establish clearly the relative responsibilities of government and the regulator. I'm hopeful that the introduction of the Strategic Policy Statement will help with this and will clarify which areas government is responsible for and which are Ofgem's. Unfortunately, the idea is that the SPS will be reviewed early in the life of each new government, so the initial version that emerges from the current process may not be the one in place in a couple of years' time.

In these circumstances, Ofgem's role for the next couple of years must be to continue to work determinedly in our own areas of responsibility to promote the interests of both current and future energy consumers.

Networks: the gold standard

First, in energy networks we should carry on as we are. Network regulation is working well. The RIIO approach has transformed the way in which the companies develop their business plans and their relationships with stakeholders. More importantly, the network businesses are still seen by their owners and investors as an attractive area for investment. People around the world still tell me that Ofgem sets the gold standard for network regulation. So my message here is simple. Network regulation isn't broken – so let's not try to fix it.

We also need to continue our important work in the supervision of the network codes and market rules which underlie the effective functioning of the wholesale markets. This is an area which most people don't even notice, but it is very important.

My lack of emphasis on networks today should not suggest that they are unimportant. We need huge investment in our energy networks to accommodate the biggest shift in generation and demand patterns for decades. But we are making a lot of progress in this area and network regulation is in good shape.

Competition in the market

In the competitive areas of the sector, following an assessment of the state of the market carried out jointly with the Office of Fair Trading and the Competition and Markets Authority (CMA), we recently announced our intention to refer the energy market to the CMA by way of a market investigation reference. We are currently consulting on this proposal, but we hope to make a final decision early this summer.

Response to this proposal has been generally favourable. The main concern has been the potentially chilling impact on investment in the sector. However, the sheer level of uncertainty about the future of the sector is already having quite a chilling effect – and I don't think the investment climate can be stabilised without first sorting out the concerns about whether the market is properly competitive. I think the reference is the correct response and I hope that, at the very least, the CMA's eventual proposals will substantially narrow the scope for debate and disagreement.

The proposed reference does not mean that Ofgem activity has to come to a stop for 18 months – far from it. We have largely implemented our reforms to the retail market, especially in reducing

tariff complexity, simplifying bills, and introducing standards of conduct for suppliers. But we have more to do in this area, including making switching times faster.

Compliance

There is an interesting debate going on between Ofgem and the companies on standards of conduct. We want the standards to apply at a high level of principle, and it should be for the companies to translate that into action. We are under pressure to explain in more detail what we would regard as compliance with the standards. But the standards should not become checklists for compliance. The onus must be on the companies to work out for themselves what behaving fairly towards their customers means in practice – and we should be ready to take strong enforcement action if they fall short. If this principles-based approach works, I hope that it will eventually reduce the need for more detailed and prescriptive regulation.

Smarter metering and smarter markets

There is a lot of activity happening in Ofgem around smart meters and smarter markets. Smart metering represents a potentially major change to the market. It will allow consumers to engage more effectively and could produce major benefits in terms of efficient use of generation capacity and networks. But it won't happen without some work from us on improving the industry settlement system, substantially reducing switching times and creating the regulatory and commercial framework for demand-side response.

Conclusion

To sum up, the situation in the energy sector is particularly complex and difficult at present, but Ofgem's basic purpose remains very clear. It is to promote the interests of consumers, both today and in the longer term, by promoting competition where appropriate and by effective regulation in the areas that remain as monopolies. Our firm intention is to pursue these objectives to the best of our ability and to do whatever we can to maintain the coherence and predictability of energy regulation in a changing world.