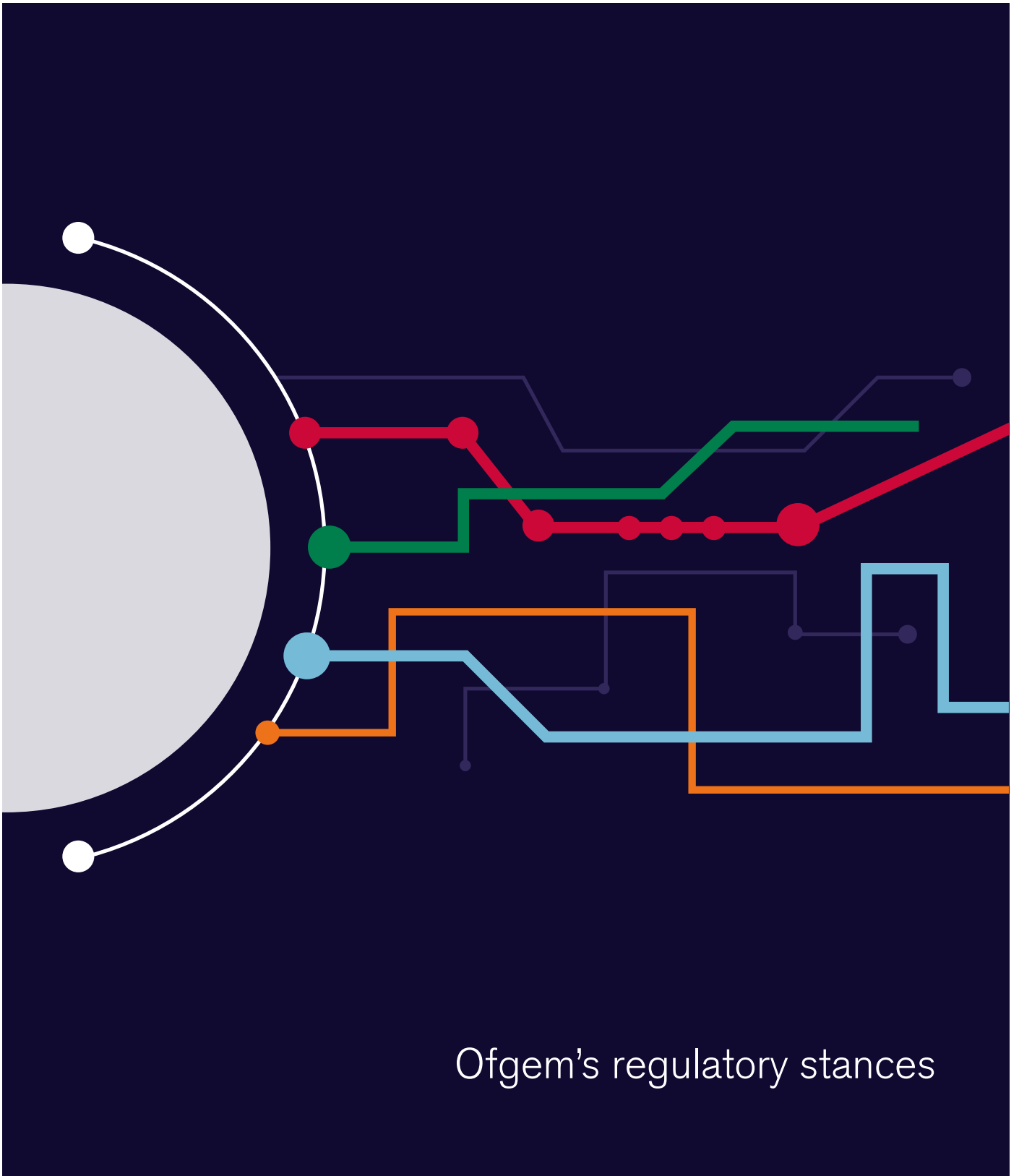


ofgem

Making a positive difference
for energy consumers



Ofgem's regulatory stances

Ofgem's

Regulatory stances

Ofgem's regulatory stances provide further detail to support the approach set out in our strategy¹. They offer a set of key principles for Ofgem to consider when we are developing policy, showing how we will use our powers to benefit consumers.

There are five regulatory stances:

1. Promoting effective competition to deliver for consumers
2. Driving value in monopoly activities through competition and incentive regulation
3. Supporting innovation in technologies, systems and business models
4. Managing risk for efficient and sustainable energy
5. Protecting the interests of consumers in vulnerable situations

We need them because they will help us to deliver our strategic outcomes for consumers, which are:

- Lower bills than would otherwise have been the case
- Reduced environmental damage both now and in the future
- Improved reliability and safety
- Better quality of service, appropriate for an essential service
- Benefits for society as a whole including support for those struggling to pay their bills

We need to deliver these outcomes in an energy system that is rapidly changing. While we can't predict exactly how the energy system will evolve, we do have a clear view about the features that will be needed.

For example, we believe that the energy market should provide genuine choice and offer the

services that consumers want. Consumers should be confident that they're getting a fair deal and that they will be treated well by their energy companies. We also believe that licensees should take more responsibility for their customers, especially those in vulnerable situations, not just by following detailed regulatory rules but by knowing and meeting their customers' demands. Companies should benefit from good decisions and face the consequences of poor performance.

To achieve this, Ofgem should:

- Promote competitive markets, where that is efficient and the benefits of introducing competition outweigh the costs
- Ensure that charging for monopoly services reflects incremental costs and benefits and recovers other revenue requirements in ways that minimise distortion
- Provide a predictable regulatory regime which supports efficient investment and allocates risks efficiently
- Ensure that regulation is neutral between different technologies, systems and business models, while encouraging new entry and innovation by, for example, promoting a level playing field between entrants and existing companies
- Focus our work clearly on delivering our strategic outcomes, streamline the rules where appropriate and work with government, industry and other partners to achieve outcomes more efficiently

This view of what's needed now and in the future underlies our regulatory stances. Their aim is to enable us to better deliver our consumer outcomes by giving Ofgem policy-makers key principles to inform their work.

¹ https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/corporate_strategy_0.pdf

How the regulatory stances apply to our work

Our stance on **promoting effective competition to deliver for consumers** sets out how we will continue to promote competition in the retail and wholesale markets, where competition is already relatively well developed. This benefits consumers by encouraging firms to compete on price and quality and delivering innovation and improved standards. But markets need rules to operate effectively, and the complexity of energy as a service means that energy market rules need to be extensive. Our role is to ensure that the rules help to create the conditions in which competition can flourish. We also need to ensure standards for consumers that reflect the fact that energy is an essential service.

We regulate different types of monopoly activities and this is covered by our stance on **driving value in monopoly activities through competition and incentive regulation**. But we know that such activities can be exposed to competitive pressures in different ways, for example through competitive tendering, and how we can introduce competitive pressure may change over time.

The next two stances on **supporting innovation in technologies, systems and business models and managing risk for efficient and sustainable energy** reflect that the energy system is transforming. New technologies and the need to reduce carbon emissions while keeping bills as low as possible present major challenges. Neither competitive markets on their own nor traditional regulation of monopolies will bring about the changes that can best deliver our strategy. Our stances on innovation and risk reflect our role in this transition.

Some energy consumers are more at risk of poor outcomes. This could be because of their individual or household circumstances. Our final stance on **protecting the interests of consumers in vulnerable situations** recognises our need to act in the interests of such consumers in line with our Consumer Vulnerability Strategy.

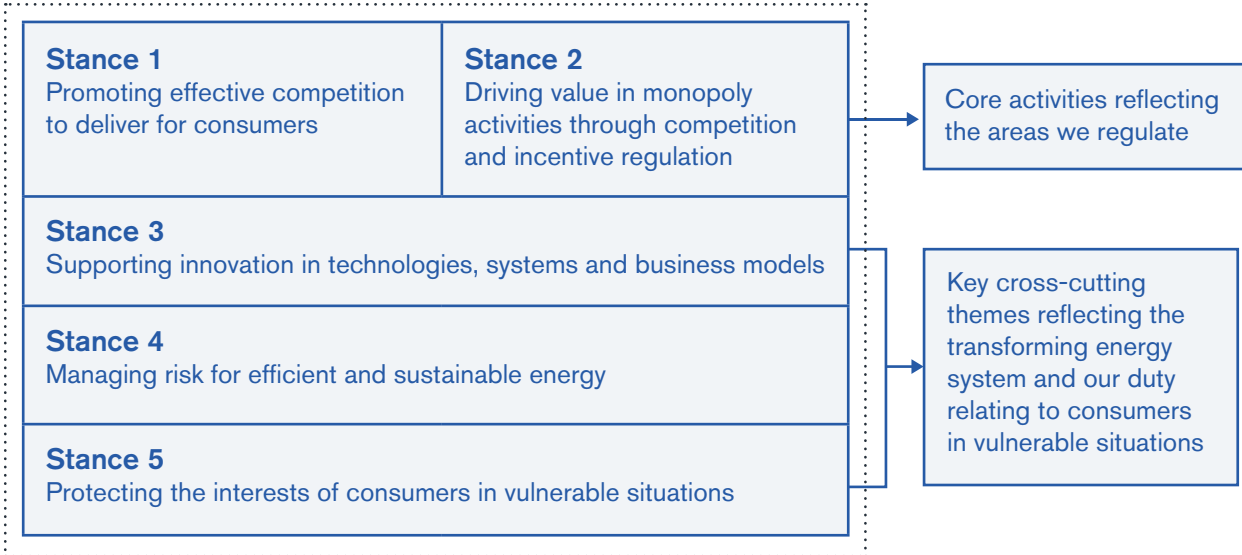


Figure 1 - Overview of Ofgem Regulatory Stances

Using our regulatory stances

These stances do not override Ofgem's statutory powers and duties. They are primarily an internal tool to give Ofgem policy-makers a framework for considering policy development. We are publishing them to inform our external stakeholders of the principles that underpin our work. They're a starting point for policy thinking, but each policy needs to be considered on a case-by-case basis and there may be times when decisions do not fully align with our stances. When this does happen, we will provide a clear explanation for this.

The five stances that we've developed don't cover everything that we do and we may publish additional stances in the future. For example we may look at the circumstances in which we use competition rather than regulation and where different forms of competition might be most appropriate. We will also keep the existing stances under review so that they remain relevant whilst the energy system is rapidly changing.

The five regulatory stances need to be considered as a package rather than individually. There is no relative ranking in terms of importance. Considering them together will help us to make balanced decisions that take account of all of our strategic outcomes. We know that sometimes, our decisions may involve trade-offs between objectives while, at other times, it may be possible to achieve several objectives at the same time.

We would welcome any feedback that you have on these stances. Please send any views to chief.economist@ofgem.gov.uk.

Regulatory Stance: 1

Promoting effective competition to deliver for consumers

Context

Competition directly benefits consumers by driving market participants to be more efficient and innovative. It puts pressure on companies to find new, efficient and better ways of doing things. Competition also encourages market participants to discover and provide the services that consumers really want. This benefits customers through lower prices and better service.

Markets need rules to operate well. The nature of the energy system means that an effective competitive market needs quite extensive rules. Our role is to set rules that allow the efficient operation of the energy system while promoting competition in a way that delivers benefits for consumers. Energy is an essential service so we may need to intervene to set standards for consumers that reflect this as well.

We also monitor markets and act if we think there's a problem with competition. This could include issuing guidance or pursuing remedies under our competition law powers but our stance doesn't dictate which approach is best. We'll consider this in a flexible way, issue by issue.

Our Stance

We believe that:

- in general, a well-functioning market which delivers competitive outcomes is the best way to protect and promote consumers' interests.
- to ensure the benefits associated with effective competition, all market participants should compete on a level regulatory playing field, on cost and non-cost issues.
- newcomers' ability to enter the market and grow their business can stimulate competition and make the energy system more diverse and innovative. Competition is also stimulated by the development of new markets, with new market participants.
- intervention may be required to foster competitive markets in the energy sector and to provide for standards that reflect that energy is an essential service.

So, our stance is to:

- create and maintain a clear, predictable framework of rules for competitive markets to allow for participants to compete effectively. Where there is evidence that markets are not delivering for consumers we will review rules and consider changes. We will use principles

rather than prescriptive rules where we can, so companies have flexibility to innovate while ensuring they think hard about delivering outcomes in consumers' best interests.

- ensure that, where market participants rely on services from other parts of the energy system, access and charging arrangements are non-discriminatory.
- address systemic, undue barriers to entry and expansion and engage with potential new entrants. We should ensure our decisions take account of the implications for new entrants and that regulation does not impose unnecessary costs on existing market participants or on new entrants.
- empower all consumers and encourage them to engage in the market, by enabling:
 - consumers' different energy needs and preferences to be met by the market
 - consumers to understand their bills and the scope for savings as well as companies' different service offerings
 - protection of consumers' rights, important standards to be met and consumers to have access to complaints processes and redress

Regulatory Stance: 2

Driving value in monopoly activities through competition and incentive regulation

Context

When regulating natural monopolies, we need to ensure they are delivering services that consumers want at efficient costs that consumers are willing to pay. We do that by harnessing the power of competition, where it is efficient to do so. This might be in how monopoly activities are delivered, who delivers them and how we regulate them.

Our Stance

We believe that:

- effective regulation should lead monopoly companies to develop and deliver strategies that maximise value for money for existing and future consumers.
- monopoly companies respond to well-designed economic and reputational incentives that align their interests with those of consumers.
- even with natural monopolies, we can harness the power of competition: we can limit the scope of monopoly activities; monopoly companies can engage with competitive markets to deliver many monopoly activities; we can hold competitions for the right to deliver monopoly services and we can use competitive processes (rivalry) to inform our decisions.
- we should be objective and evidence-based when deciding which form of competitive pressure we use.

So, our stance is to:

- use good evidence to understand how consumers value outputs, prices and risk, including inter-generational issues.

- engineer our price control processes, incentive mechanisms and reporting requirements to:
 - ensure the governance of monopoly companies and the development and delivery of their strategies are aligned with the interests of consumers, including maximising the benefits that go to consumers
 - manage uncertainty facing network companies and Ofgem, including information asymmetry, by considering all available tools
- promote competition where it's efficient to do so and the benefits of introducing competition will outweigh the costs (such as transaction costs or network effects). We use comparisons and rivalry when we regulate and, where beneficial, competitions for the right to provide monopoly services. This ensures we have best quality ex ante information about the efficient level of costs.
- implement incentive mechanisms that hold companies to account for delivering value for money against those benchmarks, taking account of both outputs (the service they provide and the service capability of the assets they hold) and costs.

Regulatory Stance: 3

Supporting innovation in technologies, systems and business models

Context

Innovation will be crucial to achieving improvements in the five consumer outcomes, and in moving to a flexible, secure and low carbon energy system. Innovation is complex: it can be encouraged by competition and enhance competition, but it also requires the financial capability and skills to take risks, experiment, learn, develop scale, deliver cost reductions and secure the corresponding rewards. We have a role to both ensure that regulatory arrangements enable innovation by allowing all market participants to compete equally and to support the process of innovation actively through funding and advice.

Our Stance

We believe that innovation:

- can have multiple benefits for present and particularly future consumers.
- spans technologies, systems and business models simultaneously.
- may often face regulatory or other barriers, particularly in the case of new business models.
- can involve both risk and reward for consumers.
- can be deterred by overly burdensome regulation or if current regulation does not ensure a level playing field for all market participants.
- can be hampered by lack of coordination, for example in developing supply chains and infrastructure for new technologies.

So, our stance is to:

- use competition as a way to drive innovation.
- encourage the industry to experiment and innovate to benefit consumers while ensuring there is adequate protection for consumers from potential downside risks of innovation.
- reduce or eliminate regulatory barriers. This could include giving companies greater flexibility by developing more general standards of conduct rather than specific rules, or providing for derogations from our rules to encourage innovation.

- ensure our decisions take account of the implications of innovation, for example the effects of new business models relative to traditional models. This will require a flexible regulatory framework that anticipates and responds to energy system changes, allowing a level playing field for new and traditional technologies and business models to compete.
- where we regulate monopoly networks, to:
 - ensure that companies have sufficient incentives to innovate, so that regulated companies and consumers can benefit if companies reduce the cost of producing their outputs or improve their service through innovation
 - support companies who want to innovate to bring wider societal benefits, where necessary through mechanisms to provide explicit funding
- consider where our actions might help mitigate barriers to innovation caused by a lack of coordination.
- engage with those developing innovative approaches to understand their ideas and concerns and help innovators assess the regulatory implications of their activities.
- work with government and industry participants to ensure that our respective roles in fostering innovation are clear and coordinated.
- be an innovative regulator, seeking better ways to improve outcomes for consumers.

Regulatory Stance: 4

Managing risk for efficient and sustainable energy

Context

Renewing and transforming our gas and electricity sectors over the next few decades requires major investment and innovation. This is needed to maintain supply security and achieve decarbonisation goals, while ensuring energy is affordable. Managing risk during this transformation is critical if we are to meet our consumer outcomes.

Our Stance

We believe that:

- companies need to have confidence in the energy market to help ensure timely investment, productive risk-taking and efficient financing costs. This will promote best value for money for consumers.
 - market confidence is supported by a stable and predictable policy environment. This means we have to make good decisions based on principles that we then stick to, particularly when they influence longer term investment decisions.
 - the challenges involved in the energy transition may call for new business, financing and regulatory models which could have significant effects on the risk environment.
 - where competition works well and consumers can make choices, risk is efficiently assigned to consumers and companies through competitive pricing.
- use this analysis to inform our policy decisions so that our greater understanding of the risk environment ultimately benefits consumers.
 - draw from a diverse range of tools to analyse risk e.g. risk mapping and modelling.
 - align our behaviour and our decisions to help minimise companies' actual and perceived regulatory and political risks.
 - ensure that consumers and companies (and sometimes taxpayers) appropriately share in the benefits and risks of providing energy services:
 - allocate risk to companies where they can respond to it more effectively through better management and innovation or more dynamic participation in markets.
 - where markets are not competitive, design our regulatory regimes to ensure companies focus on the risk they can most productively manage, so that consumers can proportionately share in the benefits.

So, our stance is to:

- be risk-aware when we make or inform policy decisions. This means we need to analyse components of risk, what drives them, how they affect market dynamics and how they affect commercial decisions.

Regulatory Stance: 5

Protecting the interests of consumers in vulnerable situations

Context

Energy is an essential service, yet some consumers can't or don't engage with the energy market. Some are more at risk of poor outcomes because of their circumstances. We will act in the interests of such consumers. We may act to reduce the cost to vulnerable customers if we believe they are suffering an unfair disadvantage. But we also believe actions primarily intended to redistribute substantial costs are a matter for government.

Our Stance

We believe:

- because of their individual or household circumstances, some consumers may be less able to engage with the energy market and / or be more at risk of poor outcomes.
- consumers can move in and out of being in vulnerable situations depending on their ability to engage or their personal or household characteristics.
- cost to serve is not the same for all groups of consumers, but the cost of energy should not be disproportionately more for consumers in vulnerable situations.
- our regulation can have an impact on the distribution of system costs across different customer groups.
- government has the primary role in addressing fuel poverty, particularly for policy aimed at redistributing substantial costs between energy consumers.

So, our stance is to:

- seek to empower and protect consumers in vulnerable circumstances when developing and implementing policy, in line with our Consumer Vulnerability Strategy which recognises that vulnerabilities can take many forms and can be temporary.
- ensure that consumers in vulnerable situations have equal access to market benefits such as competitively priced energy and

their circumstances do not put them at a disadvantage in accessing services. Where markets by themselves don't do this, we will consider appropriate actions. This could be, for example, through policy focussed on providing better information and service support or through capping of charges and prices, where appropriate.

- consider potential interventions and permit industry cross-subsidy where there is evidence that consumers in vulnerable circumstances are disproportionately affected, and:
 - the benefits to a target group are significant and the impact of redistributed costs low
 - the risks to the target group are significant
- assess the distributional effect of our decisions across the energy market and ensure that costs do not fall disproportionately on low income and vulnerable households.
- ensure that network companies have incentives to support consumers in vulnerable situations, including through engagement with suppliers and other organisations.
- consider working across sectors (e.g. water and energy) and with trusted third party organisations to achieve positive outcomes for consumers in vulnerable situations.
- recognise that government leads on those matters primarily oriented towards substantial cost redistribution.

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