

Agenda

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Does Ofgem have a future?

Tim Tutton, Adjunct Professor in the Energy Futures Lab at Imperial College, suggests that the future role of Ofgem, the energy regulator for Great Britain, could be a lot less exciting than either its own past or that of its predecessor bodies, Offer and Ofgas

In one sense, the answer to the question posed by the title of this article is obvious. Yes, Ofgem has a future, and it is underpinned not only by domestic primary legislation¹ but also by the requirements of the EU Third Internal Energy Market Package—not least the requirement that each country has an independent energy regulator with a significant jurisdiction.² However, this answer does not say much about what sort of future Ofgem has, and, in particular, what sort of influence it will have on the continued operations and development of the GB electricity and gas sectors.

The main conclusion of this article is that Ofgem's future will be different and much more 'focused' than its past. That past—including the record of its two predecessor bodies, Offer and Ofgas—has been one in which regulators were at the forefront of reshaping the industries from their immediately post-privatisation structures. This included:

- the forced divestment of power stations by the two prevailing fossil-fuel electricity generators;
- the replacement of the Electricity Pool of England and Wales by the New Electricity Trading Arrangements (NETA), and the subsequent extension of these arrangements to Scotland.

In addition, the actions of Ofgas through the 1990s were a large part of the reason for the break-up of British Gas into BG, Centrica and Lattice (the last of which was subsequently subsumed into National Grid), and the creation of a competitive gas market.

In contrast, Ofgem's current role sees it on the margins of a major structural change in the electricity industry—the 'Electricity Market Reform' (EMR)—which appears to be largely a joint production between the Department of Energy and Climate Change (DECC), which is taking the high-level policy decisions, and National Grid.

At the same time, other major industry change processes, which in earlier times might have had Ofgem in sole charge, have seen Ofgem awarded only joint custody, alongside DECC, with DECC often appearing to operate much as political commissars operated to ensure that the (deeply distrusted) Soviet Army did the Communist Party's bidding in the aftermath of the 1917 Russian revolution. These processes include:

- the Transmission Access Review (which ended with a DECC decision that flew in the face of Ofgem's recommendations);³ and
- the creation of a regulatory regime for offshore transmission.

In trying to understand why all of this has happened, and what it implies for the future role of Ofgem, it is tempting to see the issue in terms of conflicts between personalities—indeed, the early post-privatisation period of utility regulation in the UK was characterised by, among other features, the prominence accorded to individual regulators who had strong views about how the industries should operate. However, not only has subsequent restructuring of the governance of regulators—including the creation of boards and the separation of the roles of Chairman and Chief Executive—de-emphasised the part played by individuals, but what has happened to Ofgem (and what is likely to happen in future) also fits much more convincingly into the narrative of what usually occurs when a government delegates certain functions to an independent agency, especially when that agency is dealing with issues with a high political profile and when complicated trade-offs have to be made between different policy objectives.

In drawing out this narrative in relation to Ofgem and its predecessors, I cover the following in turn in this article:

- the reasons why governments typically use agencies;
- what makes the relationship between government (the 'principal') and regulator (the 'agent') work well, and what, by extension, makes it more problematic—in particular, the nature of the 'deal' between the two;
- what the initial 'deal' was between government, on the one hand, and Offer and Ofgas on the other;
- how that deal has evolved;
- what that evolution implies for the future of Ofgem.

Why do governments use agencies?

Most UK governments, including the present one, start with the aim of reducing the number of agencies and other bits of 'delegated governance' that characterise the political institutional landscape. Their success in these periodic culls is usually modest. This is not surprising, because there are good reasons for governments to use agencies, including regulators, even when they are not required by EU Directives, including the following.⁴

- Independent agencies enhance the credibility of promises made by government, by giving some assurance that future decisions will not be governed by day-to-day politics. For example:
 - the credibility of UK monetary policy has been substantially enhanced by responsibility for that policy being given to the Bank of England's Monetary Policy Committee;
 - independent utility regulation was a critical part of the assurance to the original and subsequent investors in privatised utilities.
- Agencies help to overcome information asymmetries. Even though regulators continually complain about the asymmetries that they face in relation to the companies that they regulate, agencies have a greater opportunity to accumulate knowledge of the relevant industries than mainstream government departments. Personnel may move around *within* Ofgem but, with each move, they are continuing to enhance their knowledge of the electricity and gas industries. Within the mainstream civil service, this 'constrained mobility' is less likely to happen.
- Agencies help government, at least under certain circumstances, to avoid taking the blame for unpopular policies or outcomes, albeit this assistance depends at least in part on the distance that government keeps from the regulatory body in question.

The Third Package will not, by itself, determine the level of independence and power of regulators in the UK or across the EU. Rather, it will probably provide

some sort of 'ceiling' to the level of direct government interference in the EU electricity and gas sectors. It would be surprising if past trans-European variability in direct governmental interference were not to continue after the Package has been implemented, reflecting the fact that, as described by Williamson and others, such institutional differences highlight long-lasting cultural differences between countries, as well as the more superficial and transitory 'governance' erected by new laws and regulations.⁵

Given all of this, what factors are likely to result in government agencies, and particularly regulators, being left to get on with their prescribed duties?

What makes the relationship between government and regulator work well (and what makes it work badly)?

At the end of 2007, the House of Lords Select Committee on Regulators published a report on UK economic regulators which addressed, among other issues, what was needed for the relationship between government and regulator to work well. The first paragraph of its summary of conclusions and recommendations reads as follows:

We conclude that:

1. Independent regulators' statutory remits should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how those duties should be prioritised.
2. Governments should be careful not to offload political policy issues onto unelected regulators.⁶

As envisaged by the Select Committee, therefore, this 'ideal' (and, arguably, idealistic) government–agency relationship is one in which the regulator's brief is relatively simple. Also, by implication, a less functional relationship will be characterised by many unclear and/or conflicting objectives, resulting in a government unable to resist continually interfering in the agency's activities.

The key question is thus about the nature of the 'deal' between government and agency. In practice, and as suggested in this article, the deal between government and its energy regulators started out close to the Select Committee's ideal, but has since evolved substantially.

What was the initial deal between the government and the energy regulators?

The formal 'contract' between the government and Offer⁷ was embodied in the Electricity Act 1989, and

contained three primary objectives to be shared between the Director General of Electricity Supply (DGES) and the Secretary of State:

- to make sure that licence holders are able to finance their licensed activities;
- with some qualifications, to promote competition in generation and supply;
- to make sure that all reasonable demand for electricity is met.

In practice, however, through the 1990s the emphasis was very much on the first two of these, with:

- the ‘financing’ duty largely played out in the price reviews of the transmission and distribution networks (which delivered significant political benefits by driving down network prices), and of those supply activities that had not been opened up to competition;

and

- the duty to promote competition being channelled, in electricity, primarily through the progressive deregulation of the supply market and by compelling the two major fossil-fuel generators, National Power and PowerGen, to divest significant portfolios of generating plant, and, in gas, through policies that led, albeit slightly less directly, to the break-up of British Gas.

Although ensuring security of supply was one of the primary obligations, it seemed to be largely played down. This was partly because the ‘dash for gas’ meant that there was no shortage of generating capacity, and partly because it was a matter of political and regulatory philosophy. The dominant view for much of the 1990s was that balancing supply and demand should be left to ‘the market’. This was set out in a 1982 speech by Nigel Lawson (then Secretary of State for Energy), even if it took some time after that for the philosophy to become established:

I do *not* see the government’s task as being to try to plan the future shape of energy production and consumption. It is not even primarily to try to balance UK demand and supply for energy. Our task is rather to set a framework which will ensure that the market operates in the energy sector with a minimum of distortion and energy is produced and consumed efficiently.⁸

The apotheosis of the implementation of this philosophy in electricity was the creation of NETA, through which the government and Offer demolished the one regulatory lever (the VOLL-LOLP mechanism⁹) targeted specifically at affecting the amount of available generating capacity.

Thus, for the most part, the 1990s saw the relationship between government and energy regulators coming quite close to the ideal espoused by the House of Lords Select Committee. The main objectives for regulators were few and relatively straightforward, and did not obviously conflict with each other. Compared with more recently, there was a broad alignment between a pro-competitive philosophy in government and the dominant culture in the two regulatory bodies. It also helped that energy prices were not a big political issue—partly because international energy price movements were relatively benign (from the mid-1980s to the early 2000s, the inflation-adjusted price of crude oil was generally under \$25/barrel) and partly because regulators were able to drive down network prices.

All of this added up to a world in which regulators were largely left to get on with delivering on their statutory duties without obvious major interference from government, even when major structural changes (such as NETA) were being implemented.

How has that deal evolved?

Since then, the economic and political environment in which the gas and electricity industries operate has evolved significantly.

- The Utilities Act 2000 rebalanced Ofgem’s objectives towards delivering for consumers (whose main concern tends to be energy prices), while international wholesale energy prices increased substantially from the early 2000s.
- Decarbonisation of the electricity sector is now required, for example, by the Climate Change Act of 2008 and the EU Renewables Directive of 2009.
- Concern with security of supply increased against the background of:
 - reduced gas output from the North Sea;
 - transmission-related power cuts in 2003, which created increased political desire for greater spend on energy networks;¹⁰
 - actual and anticipated closure of ageing nuclear power stations;
 - actual and anticipated closure, partly for environmental reasons, of oil- and coal-fired power stations;
 - the prospect, with the anticipated increased penetration of intermittent renewable generation, of needing greater amounts of gas-fired generation to run at low levels of utilisation in a wholesale market that pays explicitly for energy produced, and not for available capacity.

The result has been that an energy policy that previously leaned mainly to facilitating the workings of competitive markets is now concerned with fostering

environmental and social outcomes that substantially conflict with what competitive markets, left to themselves, would deliver, not least because of the currently poor relative economics of most low-carbon electricity generation technologies.

How has the government's deal with Ofgem evolved in the light of this increased complexity? There are two main formal ways in which the deal has been set out thus far.

- First, there have been successive revisions of Ofgem's duty in primary legislation, the main effect of which has been to incorporate security of supply and the reduction of greenhouse gas emissions explicitly into Ofgem's primary obligation to protect the interests of existing and future consumers. The legislation itself offers no further clues as to how Ofgem should balance the different interests of consumers, particularly the short-term cost of gas and electricity relative to longer-term costs or relative to security of supply and emissions reduction.
- Second, the government has issued 'Social and Environmental Guidance' to Ofgem, a power created by the Utilities Act 2000 and which, in principle, gave government the vehicle for suggesting to Ofgem how it should balance conflicting duties.

The only point that can be made about this guidance is that it has failed to be particularly helpful to Ofgem in how it should balance its conflicting objectives. As regards the first Guidance, issued in 2004, the degree of unhelpfulness can be gauged from the following.

The Government has not sought to rank the four objectives set out in the [2003 Energy] White Paper [achieve carbon reduction targets, maintain reliability of energy supplies, promote competitive markets in the UK and beyond, and ensure that every home is adequately and affordably heated]. It is the Government's view that these objectives can be achieved together and the Government has put in place policies designed to achieve this.¹¹

More graphic was the judgement of one MP, Andrew Stunell, on the House of Commons Standing Committee on Delegated Legislation on the draft guidelines:

I appreciate the opportunity to discuss the social and environmental guidelines, although I have some serious reservations about them. Some hon. Members may ask why we should debate the guidelines at all. Several Labour colleagues have been kind enough to say to me, "This is all motherhood and apple pie, so how on earth could one oppose it?" It is

motherhood and apple pie, but it is a very small piece of stale apple pie and the motherhood is so substandard as to attract the attention of the National Society for the Prevention of Cruelty to Children.¹²

Although DECC has since issued revised guidance (in January 2010), this has not obviously been more helpful—a judgement accepted, to some extent, by DECC itself in its subsequent review of Ofgem, in which it stated that the effectiveness of the Guidance had been 'limited' and that the Guidance would be replaced by a new statutory 'Strategy and Policy Statement'.¹³

Thus, the current position is that primary legislation obliges Ofgem to protect a number of dimensions of the interests of both existing and future consumers, without any clear guidance as to how it should make trade-offs between these dimensions. This is the current deal between the government and Ofgem.

What will be the future of Ofgem?

The current deal between the government and Ofgem thus combines two main elements.

- Even if attention is focused only on Ofgem's 'primary' obligations, these amount to protecting consumers from higher prices (consumers' own favoured definition of their own interests), facilitating decarbonisation, and ensuring security of supply—all of which in both the short term and the long term. The scope for conflict between multiple politically sensitive objectives is thus obvious.
- There is no clear guidance from government as to how Ofgem should balance these objectives.

In these circumstances, it is not surprising that the relationship between the government and Ofgem fits so neatly into the pattern described by Matthew Flinders in his book on delegated governance in Britain:

although certain powers and responsibilities may well be delegated to an agent, there is no guarantee that the principal will actually resist the temptation to interfere, particularly if the delegated issue becomes politically salient. The centrifugal pressures of delegation grate against the centripetal logic of ministerial responsibility as ministers retain a duty to intervene, or at least pay greater attention, in areas for which they are responsible that have become issues of public concern.¹⁴

Flinders goes on to outline 'ministerial control mechanisms' that can be used to keep the agency in line, including the creation of the sort of 'agency shadowing team' that has been so obvious in

processes such as the Transmission Access Review and the creation of a regulatory regime for offshore transmission.

Although everyone interested in such matters will be eager to see whether the promised Strategy and Policy Statement offers any more clarity than the existing Environmental and Social Guidance, few will be holding their breath. This is not least because the clearer the government's instructions to a regulator, the less the regulator fulfils its role as blame receptacle (for high retail energy prices, the slow growth of renewable electricity, power cuts, or whatever), and because DECC has been keener to accept the problems posed by the non-statutory status of Environmental and Social Guidance than to accept problems with the content of the guidance.¹⁵

What seems likely at present to characterise the future division of labour between DECC and Ofgem is effectively a three-way distinction between:

- big changes in the framework for gas and electricity markets, classified as 'policy' and reserved to DECC,

although, as noted above, *implementation* of the big current change (EMR) looks likely to be delegated to National Grid rather than Ofgem;

- less major framework changes, especially when important to the delivery of policy outcomes—such as the Transmission Access Review and regulation of offshore transmission—which will continue to see DECC as political commissar to Ofgem's Soviet Army;
- 'routine' regulation—network price reviews and monitoring of wholesale and retail markets—which will stay more or less under Ofgem's control.

None of this is necessarily 'wrong'. Energy is now a much more political area than it was in the 1990s, and the House of Lords Select Committee on Regulators is not alone in thinking that political decisions should be taken by politicians. However, it does mean that Ofgem's future will be a lot less exciting than its (and Offer's and Ofgas's) past.

Tim Tutton

¹ As embodied in the Gas Act 1986, the Electricity Act 1989 and subsequent revisions to these.

² Article 35(4) of the EU Electricity Directive (2009/72/EC) and 39(4) of the Gas Directive (2009/73/EC) require Member States to guarantee the independence of the regulatory authority and ensure that it exercises its power impartially and transparently. The Directives also set out minimum powers to be vested in national regulators.

³ DECC (2010), 'Government Response to the Technical Consultation on the Model for Improving Grid Access', July. Ofgem (2009), 'Ofgem's Response to DECC's Consultation on "Improving Grid Access"', December.

⁴ This section draws heavily on Thatcher, M. and Stone Sweet, A. (2002), 'Theory and Practice of Delegation to Non-majoritarian Institutions', *West European Politics*, 25.

⁵ See, for example, Williamson, O.E. (2000), 'The New Institutional Economics: Taking Stock, Looking Ahead', *Journal of Economic Literature*, XXXVIII, September.

⁶ House of Lords Select Committee on Regulators (2007), 'UK Economic Regulators', November, para 3.13.

⁷ Space limitations have meant focusing here on the electricity arrangements, but the provisions in gas legislation are similar.

⁸ Speech given at the Fourth Annual International Conference, International Association of Energy Economists, Churchill College, Cambridge, June 28th, quoted in Helm, D. (2003), *Energy, the State, and the Market: British Energy Policy since 1979*, Oxford University Press, pp. 57–8.

⁹ In the Electricity Pool of England and Wales (the pre-NETA wholesale electricity market), the 'Pool price' included a capacity element determined by the product of 'value of lost load' and the 'loss of load probability' (VOLL-LOLP). The latter reflected the extent to which electricity demand was pressing up against available generating capacity, but the former was an indexed value that the DGES could raise if it was considered necessary to encourage more generating plant to be made available.

¹⁰ See, for example, House of Commons Trade and Industry Committee (2004), 'Resilience of the National Electricity Network', March.

¹¹ DTI (2004), 'Social and Environmental Guidance to the Gas and Electricity Markets Authority', February.

¹² House of Commons Standing Committee on Delegated Legislation (pt 1), Wednesday November 6th 2002.

¹³ DECC (2011), 'Ofgem Review: Summary of Conclusions', May, p. 4.

¹⁴ Flinders, M. (2008), *Delegated Governance and the British State*, Oxford University Press, pp. 52–3.

¹⁵ DECC (2011), 'Ofgem Review: Summary of Conclusions'.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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