

Oxford Energy Comment

September 2003

WHY OFGEM?

By John Bower¹

As the new chairman and chief executive prepare to take up their posts in October it is an opportune moment to assess the future of Ofgem. This comment questions whether anyone would think of inventing the office now if it did not already exist. New legislation, some still being implemented, such as the Utilities Act 2000, Financial Services and Markets Act 2000, Regulatory Reform Act 2001, and Enterprise Act 2002 have already superseded and undermined Ofgem's regulatory powers and independence. Conversely, regulatory bodies such as the Office of Fair Trading, Competition Commission and the Financial Services Authority have seen their powers significantly strengthened. Meanwhile, a number of government departments are seeking to assert their authority in the wake of the 2003 Energy White Paper. Indeed, energy policy is in such a state of flux that it is increasingly obvious that changes will need to be made to energy market regulation to support whatever policy decisions finally emerge. What alternative forms that regulation could take, and who should do it, have not yet been addressed. The fact that Ofgem exists is not reason enough to justify that it continues in its current form, or even that it continues at all, when government departments and other regulatory bodies have far greater energy policy remits and regulatory powers.

Background

The Gas Act 1986 and the Electricity Act 1989 provided legislative authority to the Secretary of State for Trade and Industry to appoint independent directors general for gas and electricity respectively and so set in motion the creation of the Office of Gas Supply (Ofgas) and Office of Electricity Regulation (Offer).

These two Acts imposed three overriding duties on the Secretary of State, and the respective regulatory heads; to provide sufficient secure supplies of gas and electricity to meet all reasonable demand, ensure that firms in the gas and electricity industry were able to finance their activities, and to promote competition in the generation and supply of gas and electricity.

In reality, Ofgas and Offer were created to deliver a central plank of the Thatcher government's industrial policy, namely; transforming the former monopolistic public sector gas and electricity industries into competitive private sector industries and protecting the interest of consumers in terms of security of supply and controlling prices while that was achieved.

The contents of this paper are the author's sole responsibility. They do not necessarily represent the views of the Oxford Institute for Energy Studies or any of its Members.

The liberalisation process has now been largely completed, apart from the relatively minor task of incorporating Scotland into the New Electricity Trading Arrangements (Neta). Moreover, as UK energy policy is in flux as a result of the Energy White Paper, it is legitimate to ask what changes will also need to be made to energy market regulation to support the new policies, what alternative forms regulation could take, and who should do it.

Labour changes

Almost immediately upon taking office in 1997, the New Labour government began circumscribing and undermining the independence that Offer and Ofgas had previously enjoyed by announcing a review of utility regulation that culminated in the 1998 Green Paper, *A Fair Deal for Consumers*. Simultaneously, the Department of Trade and Industry (DTI) forced Ofgem to begin the Review of Electricity Trading Arrangements (Reta) in late 1997, even though Offer had previously concluded that reforming the Pool trading arrangements was unlikely to deliver any real competitive benefit.

The DTI pressed on with its own agenda by announcing the Review of Fuel Sources for Power Stations, published in 1998. As a result, the DTI introduced the gas moratorium, publicly opposed by Offer on the grounds that it would hinder the development of competition. Again Offer was ignored and subsequently combined with Ofgas, to form the Office of Gas and Electricity Markets (Ofgem), in 1999.

The Utilities Act 2000 was then introduced, which formally terminated Ofgem's independence, by abolishing the office of director general for gas and electricity and creating the Gas and Electricity Markets Authority (GEMA) and the Gas and Electricity Consumers Council (GECC) to which Ofgem would report in future.

Having effectively emasculated Ofgem, the DTI then proceeded to closely supervise every step of the consultation and implementation phase of the Neta as it dragged on through 1999 and 2000. During this period, the DTI was also instrumental in restructuring the generation sector when it brokered a deal with National Power and Powergen to force a second round of coal plant divestments in return for allowing them to vertically integrate with supply.

Defining moment

The Utilities Act was a defining moment in Ofgem's role in the UK regulatory framework because it gave the Competition Commission (previously the Monopolies and Mergers Commission) authority to veto any licence modifications granted or imposed by Ofgem. The Competition Commission duly exercised its new power a few months after the Utilities Act came into force when it overturned the imposition of the Market Abuse Licence Clause, the only wholesale market reform Ofgem had been wholly responsible for since 1997.

As well as making it a subsidiary regulatory authority, the Utilities Act also simultaneously had the effect of putting Ofgem under the direct control of the Secretary of State who, as the relevant clause rather pregnantly puts it, "shall from time to time issue guidance about the making by the Authority (i.e. GEMA) of a contribution towards the attainment of any social or environmental policies set out or referred to in the guidance".

The Utilities Act therefore profoundly changed the nature of Ofgem's role in a way that was consistent with broader changes sweeping through economic regulation instituted by the New

Labour government. Within the Cabinet Office, the Regulatory Impact Unit had been formed in 1997 to strike a balance between the economic burden that regulation imposes and ensuring fair and effective protection of the rights of firms and individuals. The Better Regulation Task Force it spawned was created to ensure that regulation and its enforcement accord with the five principles of good regulation: Proportionality, Accountability, Consistency, Transparency, and Targeting.

In addition, the Regulatory Reform Act 2001 further empowered Ministers to reform primary legislation that, in theory at least, provided the Secretary of State with authority to eliminate or change regulation without reference to Parliament — all in the name of reducing red tape. Though widely criticised as a crude initiative by a government attempting to assert centralising authority over government departments, and now it seems independent regulators too, reducing the regulatory burden on industry to stimulate economic growth has an almost Thatcherite ring to it.

Impact of the White Paper

The Energy White Paper, and the process of implementation currently being undertaken, is final confirmation of the dramatic diminution of the role of Ofgem.

A cursory textual analysis reveals the repeated use of phrases such as “we will work with Ofgem” and “we expect Ofgem to” which stems directly from Ofgem’s redefined relationship with the DTI. Now Ofgem almost acts at times as if it is part of the Energy Group, within the DTI, with special responsibility for advising on gas and electricity affairs.

In practice, the Sustainable Energy Policy Network (SEPN) is also using Ofgem as an analytical resource to carry out any policy development and implementation tasks under the White Paper that it chooses to allocate to it.

This position is quite different to the one that Ofgas and Offer originally occupied as independent regulatory bodies, separate from government, and whose directors general could only be removed for incapacity and misbehaviour. The cost of their operation was quite rightly funded by the gas and electricity industries so as to maintain their independence from government.

However, now that Ofgem is no longer an independent regulator, the gas and electricity industries have begun to show signs of resenting both the expense of funding and complying with the plethora of new regulatory initiatives that Ofgem has introduced at the behest of the DTI.

Ofgem collected £46.2 million of licence fees from the industry in 2003/03. However, as these revenues are now being used, at least in part, to fund the development of general energy policy within the DTI the question arises as to whether Ofgem should be operating what amounts to an informal tax collecting mechanism on behalf of a government department that has effectively appropriated this regulatory resource for its own use. The work of government departments has always been paid for out of general taxation, with funds voted to them each year by Parliament, not by levies directed at specific industries or groups of individuals. Since the oil industry plays a significant role in the economy, yet does not have its own regulator, some are beginning to ask whether it is fair that gas and electricity firms should have to pay what amounts to a special tax.

The contents of this paper are the author’s sole responsibility. They do not necessarily represent the views of the Oxford Institute for Energy Studies or any of its Members.

In its three-year corporate strategy, published in March 2003, Ofgem justifies its continuing role by stating that everything it does is designed to protect and advance the interests of consumers, present and future.

Broadly this work is defined as falling in two main areas; making competitive markets work successfully, and regulating the natural monopolies which run the pipes and wires. Along with its ongoing duty to ensure safe and secure supplies, it is clear that Ofgem has now been given two new areas of responsibility as a direct result of the Utilities Act in addressing environment and fuel poverty issues. However, despite gaining new areas of responsibility it is an open question whether Ofgem has any real authority to deliver on its obligations under the Act. Whether other departments and regulatory bodies, who do have the necessary powers, should take over now needs to be seriously addressed.

Competition

The Enterprise Act 2002 is another major piece of legislation that strengthens the UK competition law framework and further undermines the role of Ofgem and other independent industry regulatory bodies like it.

Here the Office of Fair Trading (OFT) will have primary responsibility for rapid investigation of potential instances of market abuse, cartel formation, price fixing and other collusive behaviour, all aimed at protecting consumer interests. Meanwhile the Competition Commission will continue to investigate mergers and acquisitions, as well as other competition issues referred to it by the OFT, but with more transparency in its decision making and the remedies it proposes. The aim is to reduce the scope for political interference and make competition regulation fairer, more consistent, and reduce the risk and cost imposed on firms wishing to merge with others.

The old role of Ofgem in promoting competition will therefore largely be usurped by the OFT and Competition Commission once the Enterprise Act is fully implemented. Any attempt by Ofgem to promote alternative competition policies in the gas and electricity industry will immediately be open to legal challenge.

While Ofgem still busies itself with the minutiae of modifications to the Neta balancing mechanism, pricing of transmission access and losses, as well as producing consultations and recommendations on a myriad of issues from takeovers and mergers between firms to facilitating entry by CHP and renewable capacity, the reality is that the Enterprise Act has removed the primary role that Ofgem has played since 1990, namely, promoting competition.

Consumer groups and industry that have concerns about competition in future will be able to approach the OFT directly without going through Ofgem, demand an investigation be carried out, and receive a response within 90 days on any issue that appears to be harming consumer interests. The OFT remedy of a 'stop now order' or even a recommendation to proceed to criminal investigation backed up by the threat of five year prison sentences in suspected cases of hard core cartels are far more powerful than any sanction that Ofgem could ever impose.

Realistically, this leaves Ofgem with no effective role in promoting competition because rulings by the OFT and Competition Commission will always take precedence. Although they will undoubtedly continue to consult with Ofgem on competition matters relating to the gas and electricity industry, and Ofgem will continue to consult and report on mergers and

acquisitions as it has done with the proposed takeover of Midlands Electricity by Scottish and Southern, the OFT and ultimately the Competition Commission will be under no obligation to accept its evidence or recommendations.

They will be free to place an equal or greater weight on evidence presented by others or their own findings unearthed by their own investigations. Ultimately, competition decisions will be made by the OFT and Competition Commission, as they should be, and firms will be well aware of that in their dealings with Ofgem.

While Ofgem still has a formal duty under the Utilities Act to promote competition, in practice, all it can do is bring matters of concern to the attention of the OFT who will then decide whether to pursue them through referral to the Competition Commission (or presumably Crown Prosecution Service) or seek a remedy under its own powers. There is a wide range of consumer groups including GECC, industry participants, and government departments who are all equally capable of performing that role as well as the OFT itself.

Ofgem is not a prerequisite for monitoring competition issues in the gas and electricity industry nor does it have any real powers to promote or enforce it. The general principle that it is always better to combine responsibility with authority to act must apply, even in the case of competition in gas and electricity markets, and that means giving OFT and Competition Commission full jurisdiction – and thereby relieving Ofgem of its responsibility.

Natural monopoly

Most economists accept that certain industries have natural monopoly characteristics because the minimum efficient scale is so large that even if competing firms existed the scale economies that could be captured by merging their operations makes it inevitable that a monopoly would always be created.

Transmission and distribution networks are classic natural monopolies and the role of regulation in this environment is to ensure that the majority of the economies gained by allowing a monopoly to form are passed on to consumers and that the monopoly itself is prevented from exercising market power to set prices at the monopoly level.

The periodic distribution price control review and transmission price control review that Ofgem and its predecessors have carried out are the main mechanisms by which it has delivered under its obligation to control natural monopoly power and in particular by use of RPI-X price caps.

However, Ofgem has no remit over offshore networks for oil, gas and electricity even though dominant ownership and exercise of market power through discriminatory transit tariffs and capacity allocation could have major implications for competition and energy security in future. As energy imports will come to dominate the UK energy industry over the next two decades, and interconnections with an integrated European Union (EU) Internal Energy Market (IEM) for gas and electricity will be the main route by which energy will be delivered, this is a major gap in the regulatory framework that must be closed.

Consistency between the regulated transit and connection tariffs on offshore and onshore networks will be crucial to prevent regulatory arbitrage. The creation of Ofgem itself was

partly in recognition and a response to the inconsistency that had arisen in regulated tariffs in onshore gas and electricity transmission networks.

Decisions made by firms about new investment in network capacity, maintaining existing capacity, exploiting residual North Sea gas and oil fields, or building LNG import terminals and power plant capacity, could become heavily distorted if transmission tariffs remain heavily regulated onshore while a laissez faire attitude persists offshore.

Regulatory consistency will be crucial and since this issue will cover all forms of energy including coal, oil, and renewables and has implications in end user markets beyond electricity generation, Ofgem does not have the necessary skills, capacity, powers or remit to address them. The relevant government departments must be responsible for creating and integrating the necessary policy and legislative framework, especially the DTI.

The OFT and Competition Commission already have the necessary skills, powers and remit across all industrial sectors to implement competition remedies. Logically, therefore, there is no future role for Ofgem to play in the regulation of natural monopoly energy networks.

The only issue that therefore remains to be resolved is how responsibility for natural monopoly regulation in gas and electricity networks can be efficiently transferred to these new bodies without losing the accumulated skills and knowledge that reside within Ofgem from previous price control reviews.

Security of supply

The Financial Services Authority (FSA) became the single regulator for financial services in the UK on 1 December 2001 when the Financial Services and Markets Act 2000 came in to force. Its remit covers both wholesale and retail financial markets and firms operating in either must be registered with the FSA, comply with its risk reporting and monitoring procedures, as well as demonstrate that they have sufficient capital to withstand losses arising from any residual financial and credit risk exposures.

Prices in wholesale gas and electricity markets can exhibit extreme volatility, many times that seen in other commodity and financial markets, and as a result firms that once were utilities with stable regulated profit margins are now dominated by trading operations dealing in ever more complex derivative financial instruments to manage this volatility.

These instruments can rapidly accrue market and credit equivalent risk exposures measured in billions of pounds yet, despite this, generating and supply firms have been allowed to operate in the wholesale gas and electricity market with balance sheets dominated by debt finance, slender capital reserves, and often without recourse to parent company support should they meet with adverse trading conditions.

From 1995 onwards, Ofgem presided over and failed to prevent what effectively became a 'race to the bottom' as new entrants and incumbents alike took on increasing levels of financial and operational gearing in an attempt to deliver higher and higher returns on shareholder's equity. The end result, as we now know, has been the financial collapse of TXU, British Energy, AES Drax, almost all of the independent power producers that built new combined cycle gas turbine plant, and a significant number of gas and electricity supply firms. Physical security of supply has been undermined as a result and National Grid Transco

The contents of this paper are the author's sole responsibility. They do not necessarily represent the views of the Oxford Institute for Energy Studies or any of its Members.

(NGT) was recently left with no option but to step in and sign a highly controversial bilateral contract with AES Drax, which effectively granted the plant a quasi 'constrained on status', so as to maintain system reserve margin above critical levels.

If these firms had been banks or financial institutions trading in wholesale capital markets the FSA would undoubtedly have placed them under close supervision and required those that breached minimum capital adequacy rules either to reduce their trading activities, hedge their risk exposures, and or seek fresh capital. In extremis, the Bank of England and FSA would have acted together to stabilise the market and shut down firms overnight by withdrawing their licences and forcing an orderly liquidation of assets and liabilities. It is inconceivable that three large banks or financial institutions would have simultaneously been allowed to carry on trading in the UK and international wholesale capital market, while teetering on the edge of bankruptcy for almost two years, and threatening on an almost daily basis to default on their obligations.

Threat

The gas and electricity industry is as central to the UK economy as the banking system yet Ofgem has allowed security of supply to be threatened by the weak financial state of many industry participants because it is not equipped with the skills, the resources, or the necessary enforcement authority to require firms to effectively monitor, manage or mitigate the financial risks they were taking, or limit the threat they pose to the gas and electricity system and other participants.

Since banks, commodity trading houses, and exchanges trading energy, including those trading gas and electricity, are already required by law to be FSA registered and compliant with its financial risk reporting and monitoring standards it is glaringly inconsistent that the regulation of their largest counterparties, namely gas shippers, generating and supply firms, does not require them to comply with the same standards when they have demonstrably posed the greatest risk to financial and physical security of the gas and electricity system of the UK.

The Energy White Paper emphasises market mechanisms as a key route to delivering its goals and, with the introduction of new commodity markets for emissions, the complexity and level of derivative trading activity as well as integration between energy and other parts of the financial system will undoubtedly increase.

Since the FSA already has the necessary monitoring and reporting procedures in place, as well enforcement authority, it would be a logical and relatively simple step to place responsibility for the financial security of UK wholesale energy markets within its remit and remove this responsibility from Ofgem entirely.

The fact that banks and other financial institutions now also routinely sell energy and other utility services into retail markets, and Ofgem has no remit to regulate in the financial services industry at all, suggests that the retail energy market regulation relating to financial stability of suppliers would also be better monitored by the FSA.

Fuel poverty and environment

Although Ofgem personnel will undoubtedly be involved in the consultation processes surrounding the Energy White Paper, the government is driving its policy issues and DTI,

The contents of this paper are the author's sole responsibility. They do not necessarily represent the views of the Oxford Institute for Energy Studies or any of its Members.

HM Treasury as well as other government departments are already in direct negotiation with the energy industry over the economic and legislative mechanisms that will be used to deliver its policy objectives.

While Ofgem may ultimately be tasked with monitoring and licensing the delivery process, as it is now with the Renewable Obligation Certificates register, it will play no part in either framing the legislation and regulations or the investment and trading decisions that firms make in response. Whether Ofgem is involved in the preceding discussion, or not, will make no difference to the outcome.

It could be argued that the greatest contribution Ofgem could have made on both the environment and fuel poverty issue would have been to ensure that competitive wholesale and retail gas and electricity markets prevailed.

After all, competition delivers economic efficiency by making prices reflect marginal costs, which logically must benefit poorest consumers the most, and promotes technical energy efficiency that clearly results in reduced emissions.

However, as already discussed, competition does not uniquely affect the energy industry but every aspect of economic activity. Delivering and safeguarding competitive markets to the benefit of consumers is very clearly the goal of the OFT and Competition Commission and they have been given the necessary powers to deliver it.

Since there is no effective direct role for Ofgem to play in dealing with the environmental impact of energy or reducing fuel poverty, and as it will always have to refer and defer to the decisions of OFT and Competition Commission on competition issues, the plain fact is that Ofgem has no power to implement policy in these two areas. It should therefore have the responsibility for delivery also removed.

Conclusion

Given the discussion above, and the general conclusion that the obligations imposed on Ofgem by the Utilities Act would be better addressed by other departments and regulatory bodies, then it is hard to find a strong argument for its continued existence.

There is a wind of change blowing through the way that competition in UK industry is regulated and there is no reason to believe that energy, and especially gas and electricity markets will escape.

Pressure for change is also coming from the new multifaceted energy policy set out in the Energy White Paper and from EU directives.

Although competition is still one of its aims, the issues of emission reduction, security of supply, and fuel poverty now have an equal prominence. The role that Ofgem now plays will continue and new roles will emerge, such as monitoring financial stability of the industry in the light of increasing levels of wholesale energy and emissions trading.

However, other bodies that have responsibility for the rest of UK industry and the wider economy already play all of these roles. Although absolutely essential, and in so many ways

extremely successful at delivering the Thatcherite liberalisation energy policy of the 1990s, Ofgem has been rendered irrelevant by the new regulatory and energy policy of New Labour.

Ofgem could carry on doing what it now does, advising and monitoring the implementation of policy but the days when it had the power to act independently to shape the gas and electricity industry without the permission and backing of government departments and regulatory bodies effectively ended in 1997.

The willingness of the current government to carry through reform in this area should not be underestimated. For example, the Office of the Rail Regulator came close to being disbanded, and its powers given to the Strategic Rail Authority, as a result of recommendations from the RIU. Although the DTI has since pulled back from implementing this, after opposition from the rail industry, the Strategic Rail Authority is almost identical in form to GEMA. In addition, Oftel (telecoms regulator) has been subsumed into the Office of Communications largely as a result of its perceived failure to force BT to unbundle 'local loop' assets and facilitate the delivery of competitive broadband internet services.

The government should seriously consider closing down Ofgem and formally assigning responsibility for wholesale and retail energy market security and supervision to the FSA, competition issues including periodic review of natural monopolies to the OFT and Competition Commission, and retaining responsibility for social and environmental policy within the relevant government departments.

I have no doubt that the incoming chairman and chief executive will react vehemently to the suggestion that Ofgem should be closed down, arguing that it is involved in many important policy initiatives that cannot simply be abandoned.

I do not disagree that regulation of gas and electricity markets will continue, but there is a tendency in all bureaucracies for them to develop and recreate themselves to the point that they become self sustaining, taking on new roles as the original purpose of their creation disappears and is eventually forgotten.

The acid test for the relevance of an organisation must always be to answer the question – if it did not exist would we have to invent it now? In the case of Ofgem, the answer must clearly be no because it and its predecessors were created for a specific purpose that has now been largely achieved. The gas and electricity industry is fundamentally no different from any other industry and the policies and regulation that shapes it must therefore be consistent with the rest of the economy.

An orderly transfer of powers from Ofgem would be a far better outcome than the confusing and costly bureaucratic battle over policy and regulatory jurisdiction that is currently being played out. The distribution price control review should be completed by the end of 2004, before which many of the ongoing consultations and policy initiatives will also be completed or could easily be transferred to the DTI and subsumed into the Energy White Paper implementation. Surely 31 March 2005 would therefore mark an opportune moment to switch off the lights at 9 Millbank for one last time?

ⁱ John is Senior Research Fellow at the Oxford Institute for Energy Studies, with primary responsibility for leading the electricity market research programme and contactable at john.bower@oxfordenergy.org. The text of this comment was originally published in *Power UK* (August 2003), No. 114, pp.13-18. The views expressed are those of the author and do not necessarily reflect those of OIES.