

EXPLANATORY MEMORANDUM TO THE ELECTRICITY AND GAS (INTERNAL MARKETS) REGULATIONS 2011

2011 [No. 0000]

1. This explanatory memorandum has been prepared by the Department of Energy and Climate Change (DECC) and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The Electricity and Gas (Internal Markets) Regulations 2011 (“the Regulations”) make amendments to electricity and gas legislation and licences in order to implement, and address matters arising out of or related to, Directive 2009/72/EC (“the Electricity Directive”) and Directive 2009/73/EC (“the Gas Directive”) of the European Parliament and of the Council, concerning common rules for the internal market in electricity and gas, respectively; Regulation (EC) No 714/2009 on conditions for access to the network for cross-border exchanges in electricity (“the Electricity Regulation”), Regulation (EC) No 715/2009 on conditions for access to the natural gas transmission networks (as amended) (“the Gas Regulation”)¹ and Regulation (EC) establishing the Agency for the Co-operation of European Regulators (“the Agency Regulation”). These instruments are collectively known as the European Union (EU) Third Energy Package (“the Third package”). The Third Package repeals Directives 2003/54/EC and 2003/55/EC and Regulations (EC) No 1228/2003 and (EC) No 1775/2005.

2.2 The Regulations also provide for the enforcement, by the Gas and Electricity Markets Authority (“the Authority”), of certain provisions of Commission Regulation (EU) No. 838/2010 of 23 September 2010 (“the ITC Regulation”) on laying down guidelines relating to the inter-transmission system operator compensation mechanism and a common regulatory approach to transmission charging.

2.3 The Regulations do not make changes to the Standard Special Conditions of Gas Transporter Licences, as noted in the Transposition Note. The changes required to these conditions, to implement certain of the requirements of the Gas Directive, will be taken forward separately.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 It should be noted that the Regulations build on an established framework of domestic obligations, prohibitions and powers, found not only in legislation but also in

¹ The Gas Regulation has been amended by Commission Decision 2010/685/EU of 10 November 2010 amending Chapter 3 of Annex I to Regulation 2009/715/EC of the European Parliament and of the Council on conditions for access to the natural gas transmission networks.

licences. This framework already covers a number of the requirements in the Third Package. Given the systems that we currently have in place, and the need for regulatory consistency and certainty in order to protect industry investment, the aim has been to achieve a result that ensures proper implementation in a way that fits in with the existing regulatory regime.

3.2 The cumulative effect of the components of the Third Package (and consequently the Regulations) has led to the affirmative Parliamentary procedure being chosen in this instance. The five instruments that make up the Third Package contain measures aimed at further opening up the internal energy market to competition. Such changes come at a time when matters such as energy prices, costs to businesses and investment in ‘green’ technologies have attracted much Parliamentary interest. The Regulations themselves include a large number of textual amendments to primary legislation to substitute the existing procedure for modifying conditions of electricity and gas licences; to create a new appeal mechanism in respect of such licence modifications; to impose third party access requirements in relation to licence-exempt electricity distribution and gas pipe-line systems; to impose additional duties on owners of gas storage facilities and liquified natural gas (“LNG”) import or export facilities; to extend the existing enforcement regime, both in terms of the persons subject to the regime and the requirements to which it relates; to create two new criminal offences (albeit offences which mirror the approach taken in the existing regime, in relation to the same act in comparable contexts); and to introduce new separation of ownership requirements on those engaged in transmission activities. In addition, Part 8 of the Regulations amends the Amendment of Electricity and Gas (Determination of Turnover for Penalties) Order 2002, which was itself made under the affirmative procedure.

3.3 As highlighted in the preamble to the Regulations, the Secretary of State considers it expedient for any reference in the Regulations to certain technical Annexes to the Electricity Regulation, Gas Regulation or ITC Regulation to be construed as a reference to the appropriate Annex as amended from time to time. The Annexes in question contain technical guidelines. The Agency Regulation does not have any Annexes attached to it.

3.4 Finally, it should be noted that the new third party access requirements in relation to licence-exempt electricity distribution and gas pipe-line systems mentioned above relate to requirements contained not only in the Third Package Directives but also their 2003 ‘Second Package’ predecessors (repealed by the Third Package). In Great Britain, those requirements are imposed on licensed distributors through electricity distribution and gas transporter licences. It was considered at the time of creating those licence conditions that the European requirements were not intended to apply to persons covered by ‘de minimis’ domestic exemptions from the requirement to hold a licence. However, in 2008, the European Court of Justice (ECJ), in its judgment in the case commonly referred to as ‘Citiworks’², ruled that the German national law, which failed to impose third party access requirements on a distribution system within an airport, did not properly transpose the Directive requirements. In particular, the ECJ found that there is no general

² Citiworks AG v Sächsisches Staatsministerium für Wirtschaft und Arbeit als Landesregulierungsbehörde (C-439/06).

‘de minimis’ exception to the requirements. In light of this judgment, and following extensive public consultation by the Government, Part 6 of the Regulations introduces third party access regimes in respect of licence-exempt electricity distribution and gas pipe-line systems, as part of the implementation of the Third Package.

4. Legislative Context

4.1 The Regulations are made under Section 2(2) of the European Communities Act 1972 to implement EU law on common rules for the internal market in gas and electricity (to the extent that the existing regulatory regime does not provide sufficient coverage), and address matters arising out of or relating to those rules. They are made under the affirmative resolution procedure, for the reasons outlined above.

4.2 The Regulations make amendments to the Gas Act 1986, Electricity Act 1989, Petroleum Act 1998, Utilities Act 2000, Energy Act 2004 and Consumers, Estate Agents and Redress Act 2007. They also amend the Amendment of Electricity and Gas (Determination of Turnover for Penalties) Order 2002 and modify standard conditions of supply, transmission, transporter, distribution and interconnector licences.

4.3 Part 1 of the Regulations covers the citation, commencement and extent of the Regulations and also includes the interpretation provision. With the exception of the regulation contained in Part 2 (described below), the regulations do not extend to Northern Ireland.

4.4 Part 2 relates to Article 3 and Annex I “Measures on Consumer Protection” of the Electricity and Gas Directives. The Consumers, Estate Agents and Redress Act 2007 is amended to require the National Consumer Council to prepare and publish guidance for energy consumers, and a summary of that guidance, addressing the matters in the ‘energy consumer checklist’ published by the European Commission, in accordance with the Gas and Electricity Directives (“the Directives”).

4.5 It is worth noting that, as part of the implementation of Article 3, a number of changes will also be made to supply licence conditions, which are covered in Part 10 of the Regulations. These include a requirement on licensees to improve the current process under which customers switch supplier; send to customers a final bill six weeks after they have switched to a new supplier; and retain for at least five years, and make available to the Authority data relating to, wholesale supply contracts and derivatives. Equivalent duties, where relevant, are imposed on licence-exempt suppliers, by virtue of Part 6 of the Regulations.

4.6 Part 3 of the Regulations relates to Articles 9 to 11, 14 and Chapter 5 of the Electricity Directive and Articles 9 to 11, 15 and Chapter 4 of the Gas Directive. These require Transmission System Operators (“TSOs”), including interconnectors, to obtain certification from the Authority (using the procedure specified in the Electricity Regulation and Gas Regulation) as to the independence of their transmission activities

from any supply or production activities carried out by them or any of their affiliates. Companies must “ownership unbundle” (ie separate out the ownership of) these activities unless they satisfy one of the other grounds set out in Part 3 (referred to below as derogations) The Regulations make available, subject to specified conditions, the Independent System Operator (“ISO”) derogation from ownership unbundling requirements in both the electricity and gas sectors, and the Independent Transmission Operator (“ITO”) derogation in the gas sector. (Article 13 of the Electricity Directive and Article 14 of the Gas Directive sets out the circumstances under which Member States may provide for the ISO derogation. Chapter 4 of the Gas Directive does the same for the ITO derogation. The Electricity Directive permits the ITO derogation being given in the electricity sector also but we have decided not to make this available in Great Britain.) The certification process in Part 3 relates to the procedure required by Articles 10 and 11 of the Directives and Article 3 of the Electricity Regulation and Gas Regulation. Finally, the Regulations enable certification to be given where a TSO benefits from a “new infrastructure exemption” in accordance with Article 36 of the Gas Directive or under Article 17 of the Electricity Regulation, or where it is deemed to be in an equivalent position.

4.7 Part 4 makes changes to the statutory requirements that apply to operators of LNG import and export facilities and gas storage facilities, including changes to the existing exemption regime, requirements in respect of the operation of facilities, third party access to such facilities and (in the case of gas storage only) legal separation (“legal unbundling”) of such facilities from other gas related activities unless exempt. These requirements relate to Articles 13, 32 and 33 of the Gas Directive.

4.8 Part 5 makes provision to ensure the implementation of Article 26 of the Directives, which requires legal unbundling of distribution activities from generation and production activities.

4.9 Part 6 provides for new duties to be imposed on electricity distributors, gas transporters, and electricity and gas suppliers that are covered by statutory exemptions from the requirement to hold a licence. As mentioned in Section 3 of this Memorandum, the third party access provisions (which relate to Article 32 of the Directives) are considered to be necessary, in light of the ECJ ‘Citiworks’ case.

4.10 Part 7 makes necessary provision for the implementation of Chapter 8 of the Directives. Article 35 in the Electricity Directive (Article 39 in the Gas Directive) requires Member States to designate a regulatory authority. By virtue of Part 7, the Authority is designated as regulatory authority for Great Britain. In addition, if a representative of the Authority is appointed as the United Kingdom representative on the Board of Regulators of the Agency for the Co-operation of European Regulators (“the Agency”), under the Agency Regulation, the Authority will also be required to keep the regulatory authority for Northern Ireland informed, and to have regard to its representations, in relation to meetings and decisions of the Agency. The provisions also put in place new rules on the appointment and removal of board members and impose duties on the Authority to ensure the impartiality of its staff and board members.

4.11 Article 36 (Article 40 in the Gas Directive) requires Member States to ensure that regulatory authorities take into account particular objectives when carrying out EU regulatory functions. Article 37 (Article 41 in the Gas Directive) requires that regulatory authorities have certain duties, including monitoring and reporting duties, and sufficient information gathering and enforcement powers to carry out their functions under the Directives. Article 38 (Article 42 in the Gas Directive) requires that duties be imposed on regulatory authorities to consult and co-operate with other regulatory authorities (including related confidentiality duties). Part 7 also provides for the powers and duties contained in these Articles to be conferred or, as the case may be, imposed, on the Authority, where these are not already reflected in the domestic framework.

4.12 Part 8 contains provisions to extend the Authority's existing enforcement powers in relation to persons subject to new requirements by virtue of the other Parts of the Regulations. This Part also makes provision for enforcement of the obligations arising out of the Electricity Regulation, the Gas Regulation and the ITC Regulation by the Authority.

4.13 Part 9, alongside the implementation of the requirements on the regulatory authority covered by Part 7, makes provision for the Authority to modify the conditions of licences. This is a key mechanism, enabling it to carry out its regulatory tasks in accordance with the requirements of the Directives. Such tasks include, for example, matters referred to in Article 37 of the Directive (and Article 41 of the Gas Directive). The new process provides the Authority with the powers to modify the conditions of licences in an efficient and expeditious manner (required by Article 37(4) and by Article 41(4) of the Gas Directive), and ensures the Authority's independence and autonomy when carrying out its regulatory tasks (required by Article 35(4) and (5) and by Article 39(4) and (5) of the Gas Directive). Part 9 also introduces a new ex post appeals process, providing an appropriate appeals mechanism from such decisions for affected parties (required by Article 37(17) and Article 41(17) of the Gas Directive). An appeal against a decision of the Authority to amend the conditions of a licence may be made to the Competition Commission by the directly affected licensee, a licensee whose interests are materially affected by the decision, by a body representing such licensees or by Consumer Focus, where consumers are materially affected by that decision. The appeal is to be brought in accordance with the process specified in either Schedule 5 (modification of gas licence conditions) or Schedule 6 (modification of electricity licence conditions) of the Regulations. In order to ensure a consistent and coherent regulatory framework the changes apply to all decisions of the Authority to modify the conditions of licences, including those arising from the Directives.

4.14 Part 9, as part of the implementation of the requirements on the regulatory authority covered by Part 7, makes provision for an amended power for the Authority to modify the conditions of licences. It also introduces a new ex post appeals process, so that the Authority is able to make autonomous decisions, and is also able to implement binding decisions by the European Commission and the Agency. An appeal against a decision of the Authority to amend the conditions of a licence may be made to the

Competition Commission by the directly affected licensee, a licensee whose interests are materially affected by the decision, by a body representing such licensees or by Consumer Focus, where consumers are materially affected by that decision. The appeal is to be brought in accordance with the process specified in either Schedule 5 (modification of gas licence conditions) or Schedule 6 (modification of electricity licence conditions) of the Regulations.

4.15 Part 10 ensures that terms relating to provisions inserted by the Regulations are defined in legislation. It also modifies the standard conditions of gas and electricity licence conditions in order to impose new requirements on licensed suppliers, interconnectors, gas transporters, electricity distributors and holders of electricity transmission licences. Those modifications implement, and deal with matters arising out of or relating to, various requirements of the Directives including legal and ownership unbundling, third party access and the duties in respect of consumers mentioned at paragraph 4.4 above. Part 10 also includes a review clause for the Regulations, which places an obligation on the Secretary of State to review the implementation of the Third Package and ITC Regulation five years after the Regulations come into force.

4.16 A Transposition Note for the Regulations is attached at Annex 1.

5. Territorial Extent and Application

5.1 With the exception of the provision contained in Part 2, the Regulations do not extend to Northern Ireland. Northern Ireland will be making its own implementing regulations in respect of the Third Package.

6. European Convention on Human Rights

The Secretary of State for the Department of Energy and Climate Change has made the following statement regarding Human Rights:

In my view the provisions of the Electricity and Gas (Internal Markets) Regulations 2011 are compatible with the Convention rights.

7. Policy background

7.1 Since the mid-90s, the European Parliament and European Council have put in place legislation that aims to support the creation of a single energy market within the EU, by introducing competition and removing barriers to cross-border trade. This gradual transition has been progressed to date through two previous packages of legislation.

7.2 The Third Package sets out a number of new requirements on Member States and regulatory authorities. It includes new requirements on Member States which aim to reinforce retail market competition, increase consumer choice and consumer protection. It also gives national regulators more powers and duties and encourages cross-border co-operation, to ensure that regulation across Member States is applied consistently.

7.3 The Third Package also includes a number of measures which aim to improve security of supply by, for example, improving network access and encouraging further investment through the unbundling of transmission system ownership. New measures also aim to improve the operation of the gas storage market and LNG facilities by, for example, including requirements for the legal and operational unbundling of gas storage system operators and third party access to storage facilities that are technically or economically necessary.

8. Consultation outcome

8.1 DECC issued an eight week Call for Evidence on 1 April 2010, in which it highlighted the major new requirements in the Third Package and sought initial views on changes that might be needed to the GB framework. Following the responses to the Call for Evidence, DECC issued a twelve week consultation on 1 July where it responded to the issues raised and sought further views on initial proposals for complying with aspects of the Third Package.

8.2 Such areas included new measures to protect consumers, requirements on TSOs to ownership unbundle from electricity generation, gas production and energy supply, and new requirements on gas storage and LNG operators. DECC also highlighted that, in light of the new requirements in the Third Package relating to the independence and powers of the regulator, and the requirement for appeals rights to be made available to those who are affected by the decisions of the regulator, the current process which enables industry to effectively block the Authority's decisions ex-ante and requires a reference to another body where a blocking threshold of 20% of relevant licensees was formed, is not, in its view sufficient.

8.3 Between October and November 2010, DECC published two further supplementary consultation documents, one on proposals relating to the procedure for modifying licence conditions mentioned above, and one on the proposals relating to the provision of third party access to licence-exempt electricity and gas networks.

8.4 The Government confirmed its position in a Government Response published on 14 January 2011. The key decisions were:

- Final proposals to introduce a contractual right to allow customers to switch energy suppliers within 3 weeks. Some stakeholders maintained that current arrangements are already in line with the Directives – the Government does not agree with that position, given, for example, that there is currently no specified maximum time to switch a customer. The proposals allow suppliers to improve their systems over time rather than risk the costs and disruption of rapid change.
- Confirmation of the permitted ownership models for transmission undertakings with the addition of the ITO derogation for gas inter-connectors (and in response to stakeholder requests).

- Proposals to introduce new requirements for gas infrastructure undertakings through legislation. This was the preferred option for stakeholders.
- Proposals to reform the licence modification process to meet the requirement for the Authority to be able to take autonomous decisions in an efficient and expeditious manner and to provide all affected parties with an appropriate right of appeal. Some stakeholders argued that such a change was not required. It is the Government's view that a single licence modification process (as opposed to separate processes for purely domestic matters and matters covered by the Directives) will provide a clearer and more coherent regulatory framework.

9. Guidance

9.1 The Authority will issue guidance in relation to the certification process for unbundling to ensure that TSOs, (including offshore transmission operators, and interconnectors), all of which will be affected by the unbundling requirements, are aware of the timescales within which the Authority will need to be provided with relevant documentation in order to start the certification process. The Authority will also issue guidance in relation to the improvements energy suppliers need to make to their systems and processes to enable more people to switch within three weeks.

9.2 DECC will issue guidance on the arrangements exempt distribution network owners will have to put in place in order to give third party access to their networks. Finally, DECC also proposes to issue guidance related to Part 8 of the Regulations, to give further detail about obligations arising out of the Third Package.

10. Impact

10.1 There will be a number of new requirements on businesses, for example, on energy suppliers to make changes to IT systems so that more people switch within three weeks and to reflect on bills consumption data provided by customers to their supplier; there will also be requirements on gas storage and LNG operators to provide third party access to their facilities; on exempt distribution network owners and suppliers to provide access to their networks; transmission undertakings will need to demonstrate compliance with the unbundling requirements and may incur some administrative and legal costs.

10.2 There will be some impact on the public sector as the Authority will have new powers and duties.

10.3 An Impact Assessment for the key provisions of the Regulations, and two supplementary Impact Assessments, one relating to the proposals in respect of third party access to distribution networks and one relating to the proposed changes to licence modification procedures, are attached to this Memorandum at Annex 2.

11. Regulating small business

Some of the requirements apply to licence-exempt distribution network owners. As mentioned above, the Government has consulted separately on what action these organisations need to take to comply with the requirements and has suggested a minimum implementation approach, to ensure that these requirements are imposed in a proportionate way on these businesses.

12. Monitoring & review

DECC will be responsible for monitoring the implementation of the Third Package and ITC Regulation. As mentioned above, the Regulations include a review clause, which places an obligation on the Secretary of State to review the implementation of the Third Package and ITC Regulation five years after the Regulations come into force.

13. Contact

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