

**EXPLANATORY MEMORANDUM TO THE
ELECTRICITY AND GAS APPEALS (DESIGNATION AND EXCLUSION) ORDER 2005**

2005 No. 1646

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.
2. **Description**
 - 2.1 This Order performs two functions: (1) it designates various documents in the gas and electricity industry that will be subject to an appeal process introduced by Sections 173-6 of the Energy Act 2004, and (2) it defines certain circumstances under which an appeal will not be permitted
 - 2.2 Appeals will be permitted on decisions by the Gas and Electricity Markets Authority (GEMA) relating to modification decisions on the documents designated in the Order.
 - 2.3 Appeals will, in general, only be permitted where GEMA has made a decision on a particular modification that does not accord with the reported majority view of the industry governance panels that oversee the making and approval of modifications to the document.
 - 2.4 Appeals will not be permitted where the delay occasioned by an appeal would be likely to have an adverse material effect on the availability of gas and/or electricity for meeting the reasonable demands of consumers in Great Britain.
3. **Matters of special interest to the Joint Committee on Statutory Instruments**
 - 3.1 None
4. **Legislative Background**
 - 4.1 The order represents the final stage in the implementation of a process whereby decisions by GEMA on certain modifications to industry codes can be appealed to the Competition Commission. The appeals process is underpinned by Sections 173-176 and Schedule 22 of the Energy Act 2004.
 - 4.2 This Order is made under Section 173 of the Energy Act 2004. Section 173 provides for the Secretary of State to make an Order to designate documents for the purposes of the appeals process, as well as to describe decisions that are for the time being excluded from the right of appeal. The Order may provide for the exclusion to apply only in such cases as may be determined in accordance with the Order, and for a determination in accordance with the Order to be made by such persons, in accordance with such procedures, and by reference to such matters and the opinions of such persons (including GEMA), as may be provided for in the Order.
 - 4.3 Before making such an Order, the Secretary of State is required to consult GEMA and such other persons as he considers appropriate. The DTI carried out a public consultation on a draft Order, commencing on 4 October 2004. Fifteen consultation

responses were received, and several amendments were made to the draft Order in the light of responses received to the consultation. GEMA was also consulted, and was closely involved in the development of the final Order

4.4 It is intended that the government response to the consultation will be published at the same time as the Order is laid before Parliament.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

Not applicable

7. Policy background

7.1 The Gas and Electricity Markets Authority (GEMA) has jurisdiction over a number of documents that define the way the gas and electricity industries operate. Modifications to these documents are generally initiated as proposals made by industry participants. These modifications are subject to a variety of processes designed to achieve a consensus, which can include consultation of industry parties, voting mechanisms, and panel discussions. The appeals process applies only to situations where GEMA has to approve changes for them to take effect.

7.2 The only route to appeal GEMA decisions is currently to undertake judicial review. The Energy Act 2004 introduced a new mechanism whereby, in certain circumstances, GEMA decisions can be appealed to the Competition Commission. This will apply to decisions concerning modifications to the documents with the highest commercial significance. By restricting the right of appeal to significant and controversial decisions, the restrictions are intended to balance a desire to increase regulatory accountability by providing a rapid and accessible means of appealing decisions, with a desire not to introduce undue delay or uncertainty to the code modification process. The 'security of supply' exclusion is designed to ensure that the introduction of an appeals process does not have a detrimental effect on security of energy supply.

7.3 Appeals will be made to the Competition Commission, and will not normally take over 14 weeks. The Competition Commission has the power to suspend the implementation of an approved modification if an appeal is launched – but the appellant would need to make a sufficiently strong case on grounds of costs and the balance of convenience. (see paragraph 3 of Schedule 22 to the Energy Act 2004).

7.4 The working of the appeals mechanism will be monitored by DTI, and kept under continuous review.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

9. Contact

David Curran at the Department of Trade and Industry, Tel: 020 7215 2779 or e-mail: david.curran@dti.gsi.gov.uk, can answer any queries regarding the instrument.

REGULATORY IMPACT ASSESSMENT FOR THE ELECTRICITY AND GAS APPEALS (DESIGNATION AND EXCLUSION) ORDER 2005

1 TITLE OF PROPOSAL

- 1.1 Appeals to the Competition Commission against certain code modification decisions by the Gas and Electricity Markets Authority (Ofgem).

2 PURPOSE AND INTENDED EFFECT

Objective

- 2.1 The Government's aim is to strike a proportionate balance between increasing regulatory accountability, and avoiding unnecessary regulatory uncertainty with its associated costs (which would be likely to be passed on to consumers). This will be done by an order implementing the statutory appeals mechanism in relation to decisions made by the Gas and Electricity Markets Authority (GEMA) on modifications to certain gas and electricity industry codes.¹

Background

- 2.3 Many of the detailed rules that govern activities in the gas and electricity markets are set out in various industry codes. These codes are designed to allow ongoing amendment. Modifications can generally be proposed by any party to the code, and in some cases by selected other parties. Proposals are then considered in accordance with the modification procedure set out in the various codes.
- 2.4 Once these procedures have been completed, Ofgem generally makes the final decision as to whether a proposed modification should be accepted or rejected. Market participants' only means of appealing such decisions, prior to the introduction of the new appeals mechanism, was to initiate a judicial review of Ofgem's decision. This could be costly and time consuming.
- 2.5 Sections 173-177 of the Energy Act 2004 provide for the creation of a statutory right of appeal to the Competition Commission. The legislation is intended to prevent appeals in cases where the delay occasioned by the holding of an appeal could have a significant adverse material impact on the availability of gas and electricity to customers. It will generally also restrict the right of appeal to cases where Ofgem disagrees with the recommendation or majority opinion of the relevant code panel, if a panel is designated.

Rationale for Government Intervention

- 2.9 This appeals process represents the final stage in the fulfilment of an undertaking made in section 9.16 of the February 2003 Energy White Paper that committed the Government to "work with Ofgem to strengthen the transparency and accountability of the code modification process" and "also [to] consult on a range of further measures, including whether it would be appropriate to provide for appeals against Ofgem decisions on certain code modifications." The white paper is at:

www.dti.gov.uk/energy/whitepaper/ourenergyfuture.pdf

¹ It should be noted that *Ofgem* - the gas and electricity industry regulator - and *the Gas and Electricity Markets Authority* - the panel that determines strategy and decides on major policy issues, including modification decisions - are used interchangeably in several of the consultation responses. In this document 'Ofgem' is used as a shorthand for the Gas and Electricity Markets Authority.

- 2.10 DTI's consultation revealed a widespread concern within the gas and electricity industries about the accountability of Ofgem's decision-making process in relation to certain code modifications. Judicial Review is the only way in which Ofgem's decisions can be overturned at present and allows only an examination of the process applied to modification, its lawfulness and, to a limited extent, its reasonableness. This, in the view of a number of respondents, means that the balance of the code modification process gives too much discretion to the regulator, which could give rise to an increased risk of sub-optimal decisions being taken. The introduction of an appropriate appeals process would overcome this.
- 2.11 This legislation will affect all parties that are signatories to the designated industry codes. It will also affect various related bodies such as Energywatch, the independent consumer watchdog. It is worth noting that code signatories are under no obligation to raise, or to become a party to, appeals under the new process. The appeals process could delay the implementation of certain code modifications. However, it is worth noting that the timescale of the process is tightly defined and relatively short compared to that already taken for a modification to progress through the modification panels and regulatory approval process. Of those affected, it is not anticipated that any particular group would be more affected than any other group.
- 2.12 The appeals process is unlikely to be heavily used. Initial estimates of the number of appeals the Competition Commission would hear on an average basis range from five to ten per year, although responses to the consultation suggest that the actual figure is likely to be at the lower end of this scale.
- 2.13 The low number of expected appeals means that it is difficult to estimate details of how the number of appeals will evolve in future years. The number of appeals would be expected to be loosely correlated with the number of modifications (which is highest when the codes are newly introduced, as is currently the case with the Uniform Network Code), as well as with times where the industry is undergoing significant change (as with the introduction of BETTA, the British Electricity Trading and Transmission Arrangements, which extended the England & Wales wholesale electricity market to Scotland on 1 April 2005).

3 CONSULTATION

(i) Within Government (including regulators and agencies)

- 3.1 Energywatch, the Competition Commission and Ofgem were consulted throughout the development of the appeals process. Other government departments were also consulted at key stages of the process via the Domestic Affairs Committee.

(ii) Public Consultation

- 3.2 On 20 April 2003 the DTI issued a consultation document entitled, "Strengthening the Transparency and Accountability of the Gas and Electricity Industry Code Modification Process",² which requested views as to whether a formal appeals mechanism should be established through which interested parties could contest certain Ofgem decisions. The consultation was the fulfilment of an undertaking made in section 9.16 of the February 2003 Energy White Paper³ that committed the Government to "work with Ofgem to strengthen the transparency and accountability of the code modification process" and "also [to] consult

² www.dti.gov.uk/energy/consultations/elec_mod.pdf

³ www.dti.gov.uk/energy/whitepaper/ourenergyfuture.pdf

on a range of further measures, including whether it would be appropriate to provide for appeals against Ofgem decisions on certain code modifications.”

- 3.3 Responses to the DTI’s consultation revealed a widespread concern within the gas and electricity industries about the accountability of Ofgem’s decision-making process in relation to certain code modifications. Judicial Review is the only way in which Ofgem’s decisions can be overturned at present and allows only an examination of the process applied to modification, its lawfulness and to a limited extent, its reasonableness. This, in the view of a number of respondents, means that the balance of the code modification process gives too much discretion to the regulator, which could give rise to an increased risk of sub-optimal decisions being taken. The introduction of an appropriate appeals process would overcome this.
- 3.4 The Government’s response⁴ to the consultation was published on 7 November 2003. In accordance with the wishes of a large majority of the respondents, the DTI concluded that an appropriately structured appeals mechanism would improve the accountability of Ofgem’s decision-making process.
- 3.5 Sections 173-177 of the Energy Act 2004, introduced as a result of the consultation, provided for the creation of a statutory right of appeal to the Competition Commission.
- 3.6 A second public consultation concerned with details of the codes to be covered by the new mechanism, the thresholds under which an appeal would be allowed in the various codes, and details of the exclusion related to security of supply, was launched on 4 October 2004. The consultation is available by searching for URN reference number 04/1662 at:
- www.dti.gov.uk/publications.
- 3.7 It is worth noting that a separate consultation, concerned with details of how the process would be funded, and whether licence conditions were required in order to fund the process, was launched by DTI/Ofgem on the same date; the latter consultation can be found by searching for URN reference number 04/1661 at the same site. A further consultation, concerned with procedural details of the appeals process, titled “Rules for the Conduct and Disposal of Appeals in Energy Code Modification Cases”, was launched by the Competition Commission, and is available at:
- http://www.competition-commission.org.uk/rep_pub/consultations/current/pdf/energy_code_mod_rules.pdf
- 3.8 Responses received in connection with the consultation were published at:

http://www.dti.gov.uk/energy/consultations/consult_closed.shtml

Many changes were made to details of the policy in response to comments received: in particular, the scope of the mechanism was adjusted to encompass the new Uniform Network Code⁵ and associated short-form Network Codes, as well as selected parts of the Master Registration Agreement and Supply Point Administration Agreement. Many respondents argued that Ofgem’s final decision making powers on modifications to the latter two industry codes also had a significant commercial impact and ought to be included within the scope of the new appeals mechanism.

⁴ www.dti.gov.uk/energy/consultations/govresponse.pdf

⁵ During public consultation on the scope of the appeals process, significant changes were made to the code governance arrangements in the gas sector, which led to the introduction of the Uniform Network Code. This replaces many of the functions of the Transco Network Code, with the latter becoming a short form code. The governance of the change management process of the Uniform Network Code involves a panel making recommendations to the Authority.

- 3.9 In the light of responses received to the consultation, the formulation of the ‘security of supply’ exclusion was adjusted to better reflect the policy intent, and to make the ability to exclude decisions from appeal on security of supply grounds more explicitly related to the delay occasioned by an appeal.
- 3.10 The criteria governing the circumstances under which appeals would be allowed were also changed in the case of the several codes, in response to a general view that there would be difficulties in making the criteria in the initial proposals work in practice.

4 OPTIONS

- 4.1 Given that Parliament has enacted legislation establishing a formal appeals mechanism for the modification process (specifically, sections 173 to 176 and Schedule 22 of the Energy Act 2004), and that public consultation has identified codes to be designated and appropriate thresholds for appeals to be allowed in order for the policy objective of striking a proportionate balance between increasing accountability, and avoiding unnecessary regulatory uncertainty with its associated costs to be achieved, the options open to the Government at this stage are:
- (i) To designate the codes, and implement the proposed limitations to the right of appeal; or
 - (ii) Not to designate the codes; or
 - (iii) To designate the codes, but not implement the proposed limitations to the right of appeal.
- 4.2 An earlier option was considered in the partial regulatory impact assessment that accompanied the introduction of the Energy Act to Parliament, but it was rejected. This was the option of a non-statutory scrutiny panel that would make non-binding recommendations to Ofgem in response to “minded to” statements issued by the regulator before the publication of contentious decision letters. It was concluded that the overall net benefit from this option would not be significant on the grounds that the scrutiny panel’s powers would be very limited and so would not materially improve the accountability of Ofgem’s decision-making process.
- 4.3 The retained option is to implement the proposed limitations, and designate the documents listed in Section 2 of this document.

5 COSTS AND BENEFITS

Sectors & groups affected

- 5.1 The proposed changes will potentially impact on every firm in the gas and electricity markets that is a party to one or more of the following industry codes⁶:
- The Uniform Network Code and associated Network Codes
 - The Balancing and Settlement Code
 - The Connection and Use of System Code
 - The Master Registration Agreement
 - The Supply Point Administration Agreement
- 5.2 The proposed changes will not have a significant direct impact on customers. There is no evidence that the legislation would disproportionately impact on any particular social or

⁶ Further information on the remit of these codes is included at Annex A of this regulatory impact assessment.

racial group. In particular, all consumers benefit from the security of energy supply and a transparent and competitive market in electricity and gas.

Benefit

5.3 The benefit of option (i) is very difficult to estimate numerically, given that it exists in the form of ensuring optimum outcomes in Ofgem's code modification decisions. As a purely illustrative example of the sums that could be at stake in likely contested decisions, it is worth considering the case of Modification P98 to the BSC ("Dual Notification of Contract Positions"), which was approved by Ofgem⁷ in August 2003 despite a recommendation from the BSC Panel to reject. If – for the sake of argument and leaving aside the benefits of implementation – P98 had been successfully appealed, then the industry would have avoided significant expenditure. According to Ofgem's decision letter, the revised implementation costs amounted to £0.75-1.3 million while the ongoing costs were in the order of £175-540k per year. These sums have a net present value of £3.2-9.0 million assuming a 3.5% discount rate over a twenty-year period and that all the implementation costs are incurred in "year zero".

Costs

5.4 The direct costs of operating the appeals mechanism have been estimated by the Competition Commission as:

Competition Commission's initial set-up costs⁸ = up to £10,000
Competition Commission costs per appeal = £75,000

Estimates of the number of appeals the Competition Commission would hear on an average basis range from five to ten per year (although responses to the consultation suggest that the actual figure is likely to be at the lower end of this scale). This is equivalent to £385,000 - 760,000 per year⁹. In any individual year there could be a greater or lesser number of appeals: it is thought likely that a higher number of appeals may be brought when the system is first introduced, or at times of significant change in the industry.

5.5 Appellants and Ofgem will also both incur costs in connection with appeals. These could significantly exceed the Competition Commission's costs, but are difficult to quantify. They would be met by the parties to the appeal as directed by the Competition Commission under the general principle that the "loser" pays the costs of an appeal. As Ofgem is funded by the industry, all costs, except where the appellant is not successful, will be met by the industry (and ultimately by consumers of electricity and gas).

5.6 Under option (iii) above, it would be possible to designate the codes, but not implement the proposed limitations to the right of appeal. However, the direct and indirect costs of this option are likely to be substantially greater. Not excluding those decisions where delay caused by an appeal could have an adverse material impact on the security of energy supply would be especially costly given that continuous gas/electricity supplies are essential inputs to virtually every modern economic activity in Britain. The relationship between the volume of energy undelivered and the level of resultant economic losses is very complex, but even a short supply interruption can have cost implications in the order of millions of pounds depending on its location.

5.7 Not excluding proposed modifications whereby some form of panel agreement with Ofgem's decision is used as a filter for appeal could result in a flow of appeals attempting to frustrate the progress of particular code modifications that would disadvantage the

⁷ www.elexon.co.uk/docs/ta/modifications/modsprops/hP098/Decision_Letter_Final.pdf

⁸ Possible costs of appointment of two new members at the CC.

⁹ Or a net present value of £5.3-10.7 million, assuming a 3.5% discount rate over twenty years.

participant, even though it is generally accepted that the appealed modifications would benefit society as a whole. Such behaviour would increase the regulatory uncertainty of the modification process and significantly increase its costs, which would ultimately be borne by consumers in the form of higher prices than would otherwise be the case.

- 5.8 Consequently, the net benefit from option (i) should exceed that of option (ii) and (iii) by a large margin.

6 SMALL FIRMS' IMPACT TEST

- 6.1 None of the options impact directly on small firms because small firms are not parties to the energy industry codes. The Small Business Service has therefore confirmed that there is no requirement to carry out stage one of the Small Firms' Impact Test.

7 COMPETITION ASSESSMENT

- 7.1 Only option (iii) would impact on the degree of competition within the gas and electricity markets. This is because the regulatory uncertainty created by an excessively broad right of appeal would tend to raise barriers to entry in the industries and to militate against the profitability of smaller energy firms. This would reinforce the position of well-capitalised large firms, which are better able to withstand market risk.
- 7.2 The tightly defined right of appeal in option (i) should avoid any additional regulatory uncertainty.

8 ENFORCEMENT, SANCTIONS AND MONITORING

- 8.1 The Competition Commission is the relevant authority under both options. The Competition Commission has various powers in connection with the appeals process, as directed in Section 175 of the Energy Act 2004 and Schedule 22 to that Act.

9 IMPLEMENTATION AND DELIVERY PLAN

- 9.1 Most of those affected by this new process will already be familiar with its development. The Competition Commission, the body that will hear appeals, has been closely involved in the development of the process. The details of the conduct of the process have been published as a Schedule to the Energy Act 2004, with more detailed provisions published for consultation by the Competition Commission (as mentioned in **Section 3** of this document). It is anticipated that final rules for the conduct and disposal of appeals will be published soon after the Order being made.
- 9.2 The process will come into force for Ofgem decisions on code modifications with immediate effect from the date of the Order coming into force. For the avoidance of doubt, this means that Ofgem decisions made after the Order comes into force will be subject to the appeals process – including decisions on code modifications that passed through the various panel processes prior to the Order coming into force.

10 POST IMPLEMENTATION REVIEW

- 10.1 The usage and effectiveness of the appeals process will be monitored by DTI, with the efficacy of the legislation kept under continuous review.

11 SUMMARY AND RECOMMENDATION

- 11.1 Following a public consultation in 2003, the Government concluded that the introduction of an appropriate formal appeals mechanism for Ofgem decisions on gas and electricity code

modification would increase the accountability of Ofgem decisions. This will impact on every firm in the gas and electricity markets that is a party to the Transco Network Code, Uniform Network Code, Balancing and Settlement Code, Connection and Use of System Code, Supply Point Administration Agreement and Master Registration Agreement.

- 11.2 The principal benefit of this policy is to minimise the risk of sub-optimal regulatory decision-making. The total direct costs incurred by the Competition Commission in connection with a statutory appeals mechanism are estimated to be £385,000 - 760,000 per year. In addition, there are likely to be significant costs incurred by appellants and Ofgem, which are difficult to quantify but are limited by the tightly constrained right of appeal and compressed timescale of the appeals process. As Ofgem is funded by the industry, all costs, except where the appellant is not successful, will be met by the industry - and ultimately by consumers of electricity and gas. Where the appellant is not successful, all costs would be met by the appellant; given the competitive nature of the electricity and gas markets it is unlikely that such costs would be passed on to consumers.
- 11.3 With respect to the exclusion of code modifications that would have an adverse material impact on the security of energy supply or where Ofgem agrees with the opinion of the relevant panel/decision body, it is likely that excluding such modifications from the formal right of appeal would result in a significantly higher overall net benefit than not excluding them.

12. DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by

Malcolm Wicks

Minister for Energy

Date: 18 June 2005

13. CONTACT POINT:

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14. PUBLICATION REFERENCE NUMBER

- 14.1 This document is available in electronic format by searching for Unique Reference Number 05/1165 at www.dti.gov.uk/publications.

ANNEX A: THE DESIGNATED CODES

A1 The codes to be designated are:

- The **Uniform Network Code** (UNC), which sets out many of the rules of operation of the gas transportation network in Great Britain, and ensures that gas transportation services in Great Britain are non-discriminatory and consistent with system security.¹⁰ The Transco Network Code performed a similar role when the consultation was launched, but has since been converted to a short form code, with much of the operation of the gas transportation network now governed by the UNC.
- The short-form **Network Codes** associated with the UNC, which designate the UNC as the code governing specific parts of the gas transportation network;
- The **Balancing and Settlement Code** (BSC), which principally provides mechanisms for the settlement of wholesale electricity trading and for balancing the high voltage transmission network in England and Wales (and has since been extended to Scotland);
- The **Connection and Use of System Code** (CUSC), which sets out the contractual arrangements for using the electricity transmission network in England and Wales (and has since been extended to Scotland);
- Parts of the **Master Registration Agreement** (MRA), that governs the arrangements for customer transfers between electricity suppliers in the UK retail market, and the inter-relationship between metering services, customer choice and the wholesale Balancing and Settlement markets. Ofgem only has final decision making powers on changes to specific parts of the MRA (as set out in section 9 of the MRA); and
- Parts of the **Supply Point Administration Agreement** (SPAA), which has a similar remit to the MRA but in the gas markets. As with the MRA, Ofgem only has final decision making powers on changes to specific parts of the SPAA (as set out in section 9 of the SPAA).

¹⁰ The UNC applies to the gas transportation network that is, or was, operated by Transco. There are other independent gas network codes, that generally apply to localised extensions of the gas transportation network which were not developed or operated by Transco. These have their own network codes, with their own modification procedures. These codes are not covered by the new appeals mechanism.