EXPLANATORY MEMORANDUM TO

THE ELECTRICITY AND GAS APPEALS (DESIGNATION AND EXCLUSION) ORDER 2009

2009 No. 648

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

2. Purpose of the instrument

2.1 This Order extends the right of appeal to the Competition Commission against certain decisions of the Gas and Energy Markets Authority (GEMA), to include decisions in relation to the independent Gas Transporters' Uniform Network Code and the Distribution Connection and Use of System Agreement. It also sets out the circumstances in which decisions can be excluded from the right of appeal.

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

3.1 None.

4. Legislative Context

4.1 Many of the detailed rules that apply to activities in Great Britain's gas and electricity markets are set out in codes and other industry documents which have been designated by GEMA as part of the licensing framework.

4.2 These documents make provision for their ongoing amendment. Usually, proposals for modification are considered by a panel composed of industry and consumer representatives as well as independent members. The panel recommends to GEMA whether or not a modification proposal should be accepted. GEMA approves or rejects the proposal in line with the industry document's objectives and the regulator's statutory duties. GEMA is not bound to accept the Panel's recommendation but it must issue a letter setting out and explaining its decision.

4.3 Prior to 2005, the only route of appeal against GEMA's decision was by judicial review. To make the Code modification process more accountable, the Government created a statutory right of appeal to the Competition Commission under the Energy Act 2004.

4.4 This right of appeal is limited to parties who are materially affected by a particular modification. The Competition Commission may refuse to hear appeals that it deems trivial or vexatious or with no reasonable prospect of success. The right of appeal is also restricted to GEMA decisions which disagree with the recommendation or majority opinion of the industry panel or where the delay that would result from the holding of an appeal could have a significant adverse effect on consumers' continuity of energy supply. The requirements of the modification will continue as scheduled unless, following

an application, the Competition Commission decides that this would result in significant costs and that the balance of convenience does not otherwise require effect to be given to the decision.

4.5 The Competition Commission will either confirm GEMA's decision or overturn it. It will only overturn the decision where it finds that GEMA failed to have proper regard to the purposes of the code/agreement or the regulator's statutory obligations; that GEMA failed to give sufficient weight to one or more of those objectives or obligations; that the decision was based on an error of fact and/or the decision was wrong in law. If the Competition Commission overturns the decision its powers include quashing the decision, referring it back to GEMA for further consideration, and/or giving directions to ensure a licence condition has effect as if GEMA had given consent.

4.6 Six industry codes were made subject to the right of appeal in 2005.

5. Territorial Extent and Application

5.1 This instrument applies to England and Wales and Scotland.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 The documents designated by the Secretary of State are usually those which have the most commercial significance. These documents comprise multi-lateral agreements and codes governing the way industry participants operate in relation to markets and networks.

7.2 This Order makes two more documents subject to the right of appeal. These are the Distribution Connection and Use of System Agreement (DCUSA), which sets out terms for connection to and use of the GB electricity distribution network, and the independent Gas Transporters Uniform Network Code (IGT UNC), which rationalises transportation agreements between gas transporters.

7.3 The Order therefore increases the accountability of the regulator by offering market participants a right of appeal against its decisions with respect to these codes.

8. Consultation outcome

8.1 The Government publicly consulted on this measure in 2007. Nine responses were received from energy businesses and Energywatch also responded. Respondents supported the proposal. A full analysis of the responses can be obtained from the contact below.

9. Guidance

9.1 Information about the appeal process is available from the Competition Commission.

10. Impact

10.1 An Impact Assessment is attached to this memorandum.
10.2 The impact on business and other sectors is not expected to be significant.

11. Regulating small business

11.1 The legislation applies to small business.

11.2 However, although the legislation does not exempt small businesses, as the main parties to these codes tend to be larger businesses there is unlikely to be a direct impact on small businesses.

12. Monitoring & review

12.1 DECC is observing the use of the appeals system and will continue to monitor and record the nature and number of cases.

13. Contact

Keith Evans at the Department of Energy and Climate Change Tel: 0207 215 5694 or email: keith.evans@decc.gsi.gov.uk can answer any queries regarding the instrument.

Department for Business, Enterprise and Regulatory Reform	Impact Assessment for extending the Energy Act 2004 right of appeal with respect to certain GEMA Decisions (section 173)

Stage Final	Version 1 9/03/2009	Related Publications:

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What is the problem under consideration? Why is government intervention necessary?

The current right of appeal under S173 of the Energy Act 2004 against decisions by the Gas and Electricity Markets Authority (GEMA) to approve or reject modifications to certain industry codes and agreement is too narrow. Challenges to modifications to other codes are only available via Judicial Review which is expensive and lengthy.

In order to extend the scope of appeal the additional codes must be designated by Order made by the Secretary of State.

What are the policy objectives and the intended effects?

To extend the right of appeal to the Competition Commission against decisions by GEMA on proposed modifications to the electricity Distribution Connection and Use of System Agreement (DCUSA) and the independent Gas Transporters Uniform Network Code (iGT UNC). Providing wider access to the appeals mechanism enhances the accountability of the Regulator potentially avoiding unnecessary implementation costs that do not have a strong justification.

What policy options have been considered? Please justify any preferred option.

Designate the DCUSA and the iGT UNC with exclusions where GEMA agrees with industry's recommendation and where the delay occasioned by an appeal could have an adverse impact on security of supply (preferred option)

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

2013

Ministerial Sign-off For final proposal/implementation stage Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Mike O'Brien

Date:11 March 2009

Policy Option A: Include two new industry documents, DCUSA and iGT UNC, within the scope of the Energy Act 2004 appeals mechanism

ANNUAL COSTS

One off (Transition) NA Yrs 5

Average Annual Cost (excluding one-off)

£0.06m

Description and scale of key monetised costs by 'main affected' groups

Costs that result from the proposed extension exist insofar as eligible parties choose to exercise the right of appeal regarding the DCUSA and iGT UNC. Such costs are and will remain wholly voluntary. In the two years since the appeals mechanism was created, it is notable that only one case (i.e., UNC 116V) has been brought to the Competition Commission for adjudication. The total costs for the case was £151,496.33. It has been assumed that there will be 2 appeals over the next 5 years. These costs have been annutised over the period and discounted using the Green Book rate of 3.5%

Total cost (PV) £0.25m

Other **key non-monetised costs NA**

ANNUAL BENEFITS

One off NA Yrs 5

Average Annual Benefit (excluding one-off)

£0.2m – £1.4m

Description and scale of key monetised costs by 'main affected' groups

All electricity firms that are Parties to the DCUSA agreement. All independent gas transporters and shippers who interact with iGT UNC.

The net benefit of this option is very difficult to quantify with confidence, but the available evidence suggests that the most immediate benefit in this particular example is that the gas industry may avoid having to incur net costs that were estimated to be in the rage of £1-7 million. These costs have been annutised over the period and discounted using the Green Book rate of 3.5%.

Total Benefit PV £0.9m-£6.3m

Other **key non-monetised BENEFITS**
Increase in regulatory accountability.

KEY Assumption/Sensitivities Risks

Given the lack of knowledge about possible GEMA decisions in relation to the DCUSA and iGT UNC that may be successfully appealed, quantifying the future benefit with accuracy is not possible. The only example to date suggests that extending the existing right of appeal could result in industry savings of millions of pounds in present value terms as certain expenditure is avoided. These savings may, however, be reduced or withdrawn later on implementation of a revised or alternative modification proposal.

The main policy cost of option (a) is the potential increase in regulatory uncertainty, which would exacerbate market risk and thus tend to raise companies' cost of capital. The available evidence suggests that this is not a material factor when appeals are actually decided. Moreover costs that result from the proposed extension exist insofar as eligible parties choose to exercise the right of appeal regarding the DCUSA and iGT UNC. Such costs are and will remain wholly voluntary

Price Base Year 2008	Time Period Years 5	Net Benefit Range (NPV) £0.65m - £6	**NET BENEFIT** (NPV Best Estimate) £0.65m-£6m

What is the geographic coverage of the policy/option?					Great Britain
On what date will the policy be implemented?					2009
Which organisation(s) will enforce the policy?					NA
What is the total annual cost of enforcement for these organisations?					NA
Will implementation go beyond minimum EU requirements					No
What is the value of the proposed offsetting measure per year?					NA
What is the value of changes in green gas emissions?					NA
Will the proposal have a significant impact on competition?					No
Annual cost per organisation (excluding one-off)	Micro 0	Small 0	Med 0	Large 0	
Are any of these organisations exempt?					

Impact on Admin Burdens Baseline (2005 prices)

Increase of 0 Decrease of 0 **Net Impact** 0

Evidence Base
for Summary Sheets

Overview

1. The objective is to increase regulatory accountability without significantly adding to market risk by extending the right of appeal against decisions made by the Gas and Electricity Markets Authority (GEMA) with regard to proposed modifications to the electricity Distribution Connection and Use of System Agreement (DCUSA) and the independent Gas Transporters Uniform Network Code (iGT UNC). It is intended that this extension will take effect in 2009.

Background

2. At present, many of the detailed rules that govern activities in Great Britain's gas and electricity markets are set out in codes and other industry documents which have been designated by GEMA as part of the licensing framework. These industry documents include mechanisms and procedures for ongoing amendment. In most cases modification proposals are considered – and, where necessary, developed and consultation undertaken – by a panel composed of industry and consumer representatives as well as independent members. The panel then recommends to GEMA whether or not a proposed modification should be accepted.

3. Once these procedures have been completed, GEMA makes the final decision whether the proposed modification should be approved or rejected in accordance with the objectives of the industry document and the regulator's statutory duties[1]. GEMA is not bound to accept the Panel's recommendation, but it must issue a letter setting out its decision and explaining its reasons.

4. The only appeal that market participants could make before 2005 was to initiate a judicial review of the regulator's decision – an expensive and time consuming process which is typically limited to relatively narrow points of law. The Government concluded after a public consultation that the prevailing means of redress meant that the Code modification process was not sufficiently accountable. In 2005, it consequently created a statutory right of appeal to the Competition Commission against decisions by GEMA on modifications to industry codes and other documents that have been designated by Order-in-Council. This is set out in sections 173-176 of the Energy Act 2004.

5. To minimise regulatory uncertainty, the 2004 Act limits the right of appeal to parties materially affected by a particular modification, while the Competition Commission may refuse to hear appeals that it deems trivial or vexatious or with no reasonable prospect of success. Secondary legislation also restricts the right of appeal to GEMA decisions that disagree with the recommendation/majority opinion of the industry panel or where the delay occasioned by the holding of an appeal could have a significant adverse on customers' continuity of energy supply. Furthermore, the requirements of the modification will continue as scheduled unless the Competition Commission is persuaded that this would result in disproportionate costs.

6. The appeals process will normally be kept to 12 weeks and a maximum of 14 weeks. The Competition Commission judgement will confirm the decision already made by GEMA,

[1] http://www.ofgem.gov.uk/About%20us/Pages/AboutUsPage.aspx

reject it or refer it back to GEMA for further consideration taking account of certain factors. The regulator's decision will only be overturned where the Commission finds that:

- GEMA failed to have proper regard to the objectives of the code/agreement or the regulator's statutory obligations;
- GEMA failed to give appropriate weight to one or more of those objectives or obligations; or
- the decision was based on an error of fact and/or was wrong in law.

Rationale for Government Intervention

7. In terms of the rationale for Government intervention, it is proposed that the DCUSA and iGT UNC should be added to the list of industry documents to which the right of appeal applies. This list is contained in the Electricity and Gas Appeals (Designation and Exclusion) Order 2005[2].

8. Not extending the current right of appeal to future DCUSA and iGT UNC modifications limits market participants' means of recourse to judicial review. As stated above, this is an expensive process which effectively allows only an examination of the process applied to modifications, its lawfulness and to a limited extent the reasonableness of the outcome. In most cases it does not permit a meaningful examination of the merits of the decision.

Consultation

With Industry

9. A public consultation on both the proposals and a draft impact assessment was published by the Department in August 2007.

Within Government

10. The Competition Commission is content that the appeals mechanism is extended to include the DCUSA and the iGT.

Options

11. Given that Parliament has already enacted legislation to establish a formal appeals mechanism and that certain codes and industry documents have since been designated, the options currently open to the Government are:

- Designate the DCUSA and the iGT UNC in the same manner.
- Status quo

Option 1 - Designate the DCUSA and the iGT UNC in the same manner.

Benefits

12. Providing a route of appeal to the Competition Commission on modification decisions in relation to the DCUSA and the iGT UNC does not preclude companies from seeking a judicial review of GEMA decisions. However, the appeals mechanism created by the Energy Act 2004 offers a cheaper alternative on the grounds that (i) the duration of the appeal is time-limited by law; and (ii) parties are not obliged to engage senior Counsel to represent them.[3]

13. The principal benefit of extending the existing right of appeal to the DCUSA and iGT UNC is the accompanying increase in regulatory accountability. Quantifying this benefit is very difficult given the inherently intangible nature of accountability. Examination of the

[2] SI 2005/1646, which came into force on 14 July 2005.

[3] GEMA and British Gas Trading chose to make use of QCs in the appeal of modification 116V, which increased the total costs of the hearing.

Competition Commission's first ever judgement in July 2007 of an appeal nevertheless offers some illustrative figures of the potential gains.[4]

14. In December 2006 and January 2007 the UNC Panel recommended that modification 116A be approved and that all related modifications be rejected. GEMA instead decided to approve modification 116V in April 2007.[5] This was a proposal made by National Grid Gas to reform the transitional National Transmission System (NTS) offtake arrangements that took effect in 2005 following the gas distribution network sales that year. E.On UK – which was subsequently joined by British Gas Trading – appealed to the Competition Commission on a number of grounds, most of which were dismissed.

15. However, the Commission concluded that the regulator's cost-benefit analysis was inadequate essentially because:

- it attributed a "significant weight to benefits" to one aspect of the proposal[6] that would only arise under particular circumstances without "properly assessing or demonstrating the likelihood" that these circumstances would occur;
- it "did not undertake the weighting of [gas] transporters' costs in a consistent and principled way"; and
- overall, "in balancing quantified costs against qualitative benefits, GEMA failed sufficiently to explain the nature of the benefits relied on …..and the way in which the benefits had been balanced and weighed against the costs", notwithstanding the difficulties in doing so.

16. In short, the Commission found that the justification for this modification decision was not sufficiently transparent and, consequently, quashed GEMA's approval of 116V and its rejection of 116A.

17. Depending on GEMA's future decision in respect of this modification, the most immediate benefit in this particular example is that the gas industry may avoid having to incur net costs that were estimated to be in the rage of £1-7 million.[7] In the longer-term, the aforementioned Competition Commission judgement and the possibility of future appeals will incentivise GEMA to ensure that the cost-benefit analyses necessary to justify modification decisions are of sufficient quality. Given the lack of knowledge about possible GEMA decisions in relation to the DCUSA and iGT UNC that may be successfully appealed, quantifying the future benefit with accuracy is not possible. The only example to date suggests that extending the existing right of appeal could result in industry savings of millions of pounds in present value terms as certain expenditure is avoided. These savings may, however, be reduced or withdrawn later on implementation of a revised or alternative modification proposal.

Costs

18. The main policy cost of option (a) is the potential increase in regulatory uncertainty, which would exacerbate market risk and thus tend to raise companies' cost of capital. The available evidence suggests that this is not a material factor when appeals are actually decided, however. With regard to modification 116V, for instance, the Competition Commission stated that:

- "we will not on an appeal under [the Energy Act 2004] substitute our view for that of the regulator" as E.On UK submitted that modification 116A should be approved instead;

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[4] http://www.competition-commission.org.uk/appeals/energy/eon_final_decision.pdf
[5] http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/116_Decision.pdf
[6] This was the modification's "flexibility product".
[7] Page 7, Ofgem decision document, 5 April 2007. This excludes qualitative benefits, which have not been valued.

- "unless the regulator has erred in logic or principle in quantifying a benefit", then it would be "slow to overturn the regulator's quantification of that cost or benefit"; and
- "It is apparent that in making the Decision, GEMA sought to ensure that all relevant matters and purposes were addressed".

19. Costs that result from the proposed extension exist insofar as eligible parties choose to exercise the right of appeal regarding the DCUSA and iGT UNC. Such costs are and will remain wholly voluntary. In the two years since the appeals mechanism was created, it is notable that only one case (i.e., UNC 116V) has been brought to the Competition Commission for adjudication. The total costs for the case was £151,496.33.

20. The net benefit of this option is very difficult to quantify with confidence, but the available evidence suggests that it is likely to be positive.

Option 2 - Do nothing

21. The costs and benefits of the status quo – i.e., relying only on judicial review – are the opposite of those outlined in option (a). This is because GEMA accountability in respect of the DCUSA and the iGT UNC would be limited as was the case for currently designated industry codes/documents before 2005. Following a public consultation, the Government at that time concluded and Parliament legislated to provide greater regulatory accountability regarding code modification decisions so as to lower the risk of sub-optimal decision-making.

22. While extremely difficult to quantify, it is anticipated that the costs of the judicial review process and associated uncertainty would both be higher than the current appeals mechanism which has been explicitly designated to be cost-effective.

Proposals

23. The Department proposed that the appeals mechanism set out in the Electricity and Gas Appeals (Designation and Exclusion) Order 2005 should be extended to apply to decisions made by GEMA in regard to modifications to the DCUSA and the iGT UNC.

24. The Department proposed, in line with the 2005 Order, to exclude from the appeal mechanism decisions where GEMA agrees with a recommendation by the parties to the DCUSA or with a majority recommendation of the iGT Modification Panel and decisions where the delay caused by hearing an appeal could have an adverse material impact on the availability of gas or electricity for meeting demand in Great Britain. Limiting the right of appeal would help minimise regulatory uncertainty and delay in a proportionate manner.

Costs and Benefits

25. Designation of the DCUSA will potentially benefit all electricity firms in the market that are Parties to the agreement. Designation of the iGT UNC will potentially benefit all independent gas transporters and shippers who interact with them.

Small Firms Impact Test:

26. Small firms should not be directly affected by this change as the main parties to these codes are larger energy companies. Among these, there are some relatively small players and we have spoken to a number of these. In general, they do not object to the extension of the right of appeal although one of them commented that they thought the code modification procedures generally favoured larger players, who are more likely to have the resources to participate effectively in these processes. This is a common complaint about industry codes in general. Ofgem recognises this and, in line with the Government's commitment to consider small business flexibilities when regulating smaller firms, is currently undertaking a review of industry code governance procedures, which is looking at whether there are requirements that can be imposed upon code panels and administrators to consider the needs of smaller players.

Equality Assessment

27. After initial screening as to the potential impact of this policy on race, disability and gender equality it has been decided that there will not be a major impact upon minority groups in terms of numbers affected or the seriousness of the likely impact or both.

Competition Assessment

28. The proposed policy would merely extend the existing right of appeal to the Competition Commission to two new industry codes: the DCUSA and iGT UNC. This is a voluntary right and not a mandatory regulation, so it is not anticipated that either option would impact on the degree of price competition within the gas or electricity markets. Indeed, there is no evidence that the existing right of appeal has had a detrimental impact on competition.

29. The DCUSA relates to Parties that connect to Britain's lower voltage distribution networks; apart from the DNOs (which are regulated monopolists in their respective areas), this is a relatively unconcentrated group of market participants. Most gas transportation in Britain is undertaken by National Grid (another regulated monopolist), so iGTs cannot exercise any market power. Since the proposed policy would merely extend a voluntary right of appeal, it is unlikely that there are any implications for market structure, set up costs, operating costs or production choices in these sectors which are not characterised by rapid technological change. Moreover, Ofgem's view is that the electricity and gas market in Britain is generally competitive.

Enforcement, Monitoring and sanctions

30. The Competition Commission is the relevant authority under option (1). The Commission has various powers in connection with the appeals process, as directed under Section 175 of the Energy Act 2004 and Schedule 22 to that Act.

Implementation and delivery plan

31. Most of those affected by this proposal will already be familiar with the development of the appeals process. The details of the conduct of appeals have been set out in Schedule 22. The Competition Commission have published procedural rules - the Energy Code Modification Rules, to govern these appeals[8] and guidance[9] intended to complement those Rules and to assist parties concerned in appeals, and their advisers, to understand the procedural framework.

32. The right of appeal will come into immediate effect from the date of the amendment Order coming into force. Decisions made after that date will be subject to the appeals process. This will include any decisions that passed through the various panel processes prior to the amendment Order coming into force.

Post Implementation and Review

33. BERR is observing the use of the appeals mechanism introduced in 2005 and will continue to monitor and record the nature and number of cases brought and look at the costs and estimated benefits.

Summary and recommendation

34. The Government introduced a formal appeals mechanism for GEMA decisions on modifications to certain gas and electricity industry documents increasing the accountability of those decisions. The appeal mechanism was made available to a number of industry documents in existence at that time.

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[8] www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/CC10_energy_code_mod_rules.pdf

[9] www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/CC11_appeals_in_energy_code_mod_cases.pdf

35. Since that time two new documents, the DCUSA and the iGT UNC, have been designated by GEMA in accordance with the licensing regime. Both industry documents have economic impact and characteristics similar to those documents already designated and it is appropriate that the same right of appeal should apply in both cases.

36. The principal benefit of access to the appeals mechanism is to minimise the risk of sub-optimal regulatory decision-making. The costs to the Competition Commission of bringing DCUSA and iGT UNC within the mechanism are incremental given that the right of appeal already exists and is only being extended to two new, uncontroversial industry documents. Since the introduction of the appeals process in 2005 the Commission has only been asked to rule on one of GEMA's decisions.

37. There are likely to be significant costs incurred by appellants and Ofgem which are very difficult to quantify but are limited by the constrained right of appeal and the compressed timetable. Ofgem is funded by industry through licence fees and industry and ultimately energy consumers will, therefore meet all costs except where the appellant is unsuccessful. In these cases all costs will be met by the appellant; given the competition in electricity markets it is unlikely that these costs would have a material impact on consumers.

Specific Impact Tests - Checklist

Not applicable in this case.