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CMA ENERGY MARKET INVESTIGATION E3G RESPONSE TO PROVISIONAL DECISION ON REMEDIES

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The Competition and Markets Authority (CMA) has proposed a set of measures that will have a significant impact on the broader energy policy landscape including a number relating to system governance. This is an important topic that has received relatively little policy consideration. E3G¹ believes that there are significant deficiencies in current governance arrangements that are acting to the detriment of all energy consumers. However, the remedies proposed by the CMA do not present an appropriate policy response.

The issue of market governance deserves renewed attention. However, this must be based on an holistic view of energy system policy challenges rather than a narrow focus on promoting competition. Key concerns about the proposed remedies relating to system governance are:

- There is a need for independent and robust scrutiny of government policy but Ofgem is the wrong body to do this – particularly given a laser focus on promoting competition.
- The ‘linear model’ of ‘Government to Ofgem to codes’ that underpins the CMA thinking fails to recognise the increasing system-wide interactions or the need to manage future risks through strategic actions.
- In the same way that DECC policy decisions should be open to scrutiny, so should those of Ofgem. This is particularly relevant since there are a number of approaches to ‘promote competition’ in a market that is potentially on the verge of a structural and technological revolution.

The CMA should recognize that system governance is a vital and complicated issue that demands further and more broadly-based consideration. The specific recommendations should therefore be qualified in this way and presented as a contribution to the wider debate.

¹ E3G is an independent, non-profit European organisation operating in the public interest to accelerate the global transition to sustainable development. For more information see www.e3g.org.uk



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Context

The CMA has undertaken a lengthy review of the energy market and proposed a raft of measures that it considers will improve competition and, as a result, outcomes for consumers. Most of the recommendations relate to retail markets and aim to encourage consumers to switch suppliers, thereby driving out cost inefficiencies from energy supply. Meanwhile, the National Infrastructure Commission has considered the future challenges and opportunities for the energy sector and identified huge benefits available in developing smart, flexible and low carbon energy markets². This reflects the broader international debate, both within the EU³ and elsewhere⁴, with countries recognising the extent of the upcoming transformation and the need to ensure that markets and regulatory frameworks are appropriately designed to take advantage of the new opportunities.

Whilst the desire to promote competition amongst energy suppliers is important, it must be viewed within this broader agenda which has the potential to deliver far greater improvements in resource efficiency than mere switching supplier, as well as material improvements in the quality of consumer's lives. A key challenge for policy makers is, therefore, to understand the extent to which market processes alone can drive the innovation necessary to transform the energy system at the rate necessary to deliver long term policy objectives.

Apart from those recommendations relating to retail markets, the CMA has also made some significant proposals relating to overall system governance. This is an important topic that has received relatively little policy consideration. E3G believes that there are significant deficiencies in the current system of governance that are acting to the detriment of all energy consumers. However, the remedies proposed by the CMA do not present an appropriate policy response. This note therefore focuses on this issue and argues that a wider debate is required before deciding on the necessary governance reforms.

Other aspects of the proposed remedies are also troubling. In particular:

- Consideration of consumer engagement issues make no reference to the need to make significant investments in consumer premises (efficiency, low carbon heat and transport, smart) and the associated challenges of achieving consent from consumers and ensuring investment efficiency. It is worrying that a focus on switching supplier will deflect attention away from more pressing and important policy challenges.
- The proposals to introduce locational transmission loss factors do not appear to have taken into account the impact on investor perception of policy risk and the consequential impact on financing costs. This has been the principle reason why this change in trading arrangements has not been made previously.

² 'Smart Power', Report by National Infrastructure Commission:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/505218/IC_Energy_Report_web.pdf

³ Communication for the EU Commission: 'Public consultation process on a new energy market design', COM(2015) 340 final, July 15, 2015

⁴ <https://www.e3g.org/library/china-accelerates-while-europe-deliberates-on-the-clean-energy-transition>



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Deficiencies in market governance

Existing market governance structures have evolved little since privatisation despite significant changes in the technical, industrial and policy context. In consequence, there is increasing evidence that industry governance is presenting a barrier to the delivery of long term policy objectives. The problems include:

- An increasing role for Government in determining investment choice but a lack of the necessary institutions to contain the perception of policy risk and the impact on financing costs. In particular, there is no robust independent challenge of policy developments and associated transparent public debate to ensure consistency of new measures with long term policy objectives. This increases the potential for Governments to make significant changes based on short term political expedients rather than long term system benefits.
- A lack of policy coherence along the value chain, across borders and between sectors. For example, there is no level playing field between the demand side (including efficiency), where investors are expected to take full market price risk, and generation and network investments which enjoy regulatory support. In particular, there is no institution capable of taking a system-wide view to ensure the best possible value is derived from consumer and public money.
- No clear basis for taking strategic decisions aimed at managing future policy delivery risks, let alone any basis for a transparent public debate about which risks are being managed and which risks consumers and society are expected to bear.
- The absence of any governance system capable of driving decarbonisation of heat required to meet statutory carbon budgets. This is the central consumer engagement challenge facing the market and there is no evidence that existing policies or delivery structures come close to being adequate.

Where institutional developments have arisen, for example with the recently established National Infrastructure Commission, there is little clarity of how these fit with existing institutions such as Ofgem and the Committee for Climate Change. Also, discussion of any issues relating to the governance of the EU internal energy market, and how this might affect the national situation, appears off-limits until after the referendum in June.

Market governance is an important issue that deserves renewed attention. However, this must be based on an holistic view of energy system policy challenges rather than the narrow focus on promoting competition that has been adopted by the CMA.

The CMA proposals

The CMA has proposed a number of remedies that relate to industry governance. These are:

- A requirement on DECC to consult on the CfD allocation process and, particularly, any allocation outside of competitive auctions.



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- Clarification of Ofgem’s primary duty to adopt ‘competitive’ solutions by removing the requirement to consider if alternative approaches might be better.
 - Establish a requirement on Ofgem to comment on all policy proposals that affect energy markets.
 - Requirement on Ofgem to publish annually a ‘State of the Market’ report covering, among other things, the impact of decarbonisation policies and to comment on the ‘trilemma trade-offs’.
 - Create a new unit in Ofgem (the Office of the Chief Economist) with the resources capable of producing the State of the Market report.
 - Requirement on Ofgem to publish a forward strategy for industry code development and on DECC to give Ofgem the powers to drive this through (as opposed to relying on governance processes controlled by industry stakeholders)

Therefore, the CMA envisages an increased role for an Ofgem focused more sharply on promoting competition and holding Government to account for all policies that might affect this. In effect, Ofgem is being asked to provide independent scrutiny of policy development, albeit from the narrow perspective of promoting competition. Importantly, it is not clear how these proposals would address the more challenging forward issues of establishing integrated system-wide approaches, decarbonising heat or identifying the appropriate trade-off between the short term costs of managing longer term uncertainties.

E3G therefore has major concerns about the proposed remedies relating to system governance. In particular:

- There is a need for independent and robust scrutiny of government policy but Ofgem is the wrong body to do this – particularly given a laser focus on promoting competition.
- The ‘linear model’ of ‘Government to Ofgem to codes’ that underpins the CMA thinking fails to recognise the increasing system-wide interactions or the need to manage future risks through strategic actions.
- In the same way that DECC policy decisions should be open to scrutiny, so should those of Ofgem. This is particularly relevant since there are many possible ways to ‘promote competition’ in a market that is potentially on the verge of a structural and technological revolution with market creation measures arguably more important than accurate price formation.

The CMA should recognize that system governance is a vital and complicated issue that demands further and more broadly-based consideration. The specific recommendations should therefore be qualified in this way and presented as a contribution to the wider debate.

Holistic governance reform

To illustrate the scale of governance reform that might be required, and to demonstrate why the CMA proposals are inappropriate, this section contains a possible governance regime that



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would address the deficiencies identified above. It is not intended to represent definitive proposals, but rather to illustrate the scale of changes required and to promote the necessary policy conversation.

A fit-for-purpose governance regime would contain four key elements:

- An independent body publically scrutinising the Government approach to delivery of long term policy objectives. This advisory body would need to be resourced appropriately to assess the various technological and market uncertainties going forward and identify which policy delivery risks are being managed effectively and which are not.
- An independent regulator (Ofgem) responsible for ensuring delivery of policy objectives in power and gas markets. Ofgem would have control, through regulatory mechanisms, over a range of delivery actors including network and system operators at transmission and distribution levels and code/market administrators. It would ensure efficient delivery through competition where appropriate.
- Local authorities responsible for the least cost decarbonisation of the building stock in their region. They would engage a variety of delivery bodies to undertake the necessary deployment programs.
- A strategic unit within Government making energy mix, infrastructure and funding choices on the basis of forward plans and options presented by Ofgem and local authorities. This would critically involve ensuring coherence across the energy system and making strategic investments.

With the exception of local authorities managing delivery at local levels, each of the other institutional elements could effectively operate at regional or EU-level to help promote efficient operation of the EU internal energy market. This also applies to transmission system operation where a single body could operate the system at regional or pan-EU level.

This institutional structure is illustrated at high level in the following chart:

