

Title: Final Impact Assessment for Proposals for Implementation of the EU Third Energy Market Package (Over-arching IA)	Impact Assessment (IA)
	Date: 14/01/2011
	Stage: Final
	Source of intervention: EU
	Type of measure: Other

Introduction

Since the mid-1990s, the European Union (EU) has 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. A third internal energy market package (the ‘Third Package’) was adopted in July 2009 and must be transposed into national law by all Member States by March 2011¹.

The Third Package consists of two Directives – one concerning the internal market in natural gas and one concerning the internal market in electricity – and three Regulations – one on conditions for access to the network for cross-border exchanges in electricity, one on conditions for access to the natural gas transmission networks and access to gas infrastructure and one establishing a new Agency for the Cooperation of Energy Regulators (ACER).

Intended Effects

The Third Package has been designed to increase competition in many areas of the energy market, through creating a more liberalised market with enhanced consumer protection and improved functioning of energy markets. This should lead to greater security of supply, and more competitive prices and services.

- The main objective of the Third Package is to create a fully liberalised market by ensuring strong consumer protection measures are in place;
- a fully independent regulator; and
- well developed network ownership arrangements

In those areas where GB is required to take more action to ensure compliance, the costs and benefits from implementation of the Third Package will be more substantial. In other areas, we believe costs and benefits from GB’s implementation will be limited as GB is compliant in many areas but significant benefits could derive to GB from ensuring the compliance of other Member States. These benefits will come through the promotion of cross-border trade

¹ Undertakings affected by the transmission network unbundling requirements of the Third Package will have an extra year after the requirements have been transposed into law, to comply, and therefore will have until 3 March 2012.

and the lowering of barriers to market entry to additional players across the EU, which could result in lower prices for GB energy imports.

We believe that the Package will have an overall positive effect on the economy, by creating a level playing field across Europe on which UK-based companies can operate. Taken together, the measures will contribute to enhancing consumer protection, promoting competitive energy markets, increasing security of supply, reducing regulatory uncertainty, and increasing the autonomy of the National Regulatory Authority.

For most provisions of the Third Package, our final proposal for implementation represents minimum compliance, which we believe will impose a minimal burden on business while maximising the benefits of the Third Package for the UK. This option is preferred as we wish to ensure that UK business is not placed at a disadvantage in the internal market as a result of these measures. Our final proposal for implementing a licence modification appeals system to meet Third Package requirements does exceed the minimum requirements of the Directive, but we believe that our preferred option will deliver a coherent regulatory framework leading to improved decision making and greater regulatory certainty.

Measures

This Impact Assessment (IA) attempts to capture, at a high level, the benefits and costs to GB of the final proposals for implementation of the Third Package.

All of the key measures within which GB is currently non-compliant have been examined in individual Impact Assessments included in this document. Each Impact Assessment (IA) discusses the final proposals for implementation, rationale and costs and benefits in more detail, taking into account evidence received during the consultation process. These have also been summarised at the end of this Impact Assessment.

In many cases, individual measures contribute to more than one policy objective. For the purposes of this Impact Assessment, however, we have brigaded individual measures under the primary policy objective that they target.

Consumer Switching

The relevant measure requires suppliers of electricity and gas to ensure that where a customer, while respecting contractual conditions, wishes to change supplier, the change is effected within three weeks.

This measure is designed to improve the switching process for consumers by reducing the time it takes to switch. High levels of switching are associated with greater competition in the market, which should result in lower prices, increased product ranges for consumers, and increased innovation from suppliers.

Currently in the UK, it takes an average of between 4-6 weeks to switch electricity, and slightly longer to switch gas. This new measure will give consumers a legal right to switch within three weeks unless there are extenuating circumstances; for example, where the customer has not given the supplier adequate or accurate data to enable the transfer. The 3

weeks will start from the end of any cooling off period, which should not exceed 14 calendar days consumers will be given to cancel the contract. Energy suppliers will be required to make improvements to their systems and processes to ensure that as many people as possible are switched within 3 weeks. Ofgem will provide relevant guidance to suppliers about proportionate changes they need to make to their IT systems.

In practice the UK has already effective switching arrangements. This measure will reduce the time taken to switch slightly and therefore we expect the benefits to consumers to be limited.

A brief summary of the costs and benefits of the preferred option is set out in Table 1.

Table 1: Consumer Switching	
Costs	Benefits
<p>There will be costs to suppliers from making changes to their systems and processes. This is difficult to quantify at this stage as work would need to be done to review the scale of upgrades needed.</p> <p>In addition, there will be a one-off administrative cost to energy suppliers in order to amend their standard terms and conditions.</p>	<p>There will be a direct benefit to switching customers who take advantage of their new gas/electricity tariff in a reduced time. However, we recognise that this, at least in some part, represents a transfer from suppliers to consumers.</p> <p>There may be an indirect effect as quicker switching could lead to greater competition in the market.</p>

Consumer Information

The measures include a requirement on suppliers to ensure consumers are informed about their actual consumption and costs and can request that data is provided to other suppliers; a requirement for suppliers to inform customers about the means of dispute settlement available to them; an energy consumer checklist to provide consumers with information about their rights and other issues that may affect them. Finally, there is a requirement on suppliers to keep certain data at the disposal of the national regulatory authority.

These measures are designed to improve the quality and quantity of information available to consumers on both their individual consumption, their rights, and industry processes. Greater transparency and consumer awareness is a driver of competitive energy supply markets. In the long term these measures may enable consumers to better act as a competitive constraint on suppliers' pricing and provide strong incentives on suppliers to reduce costs, improve service and develop innovative products. However the proposed changes are only expected to have a minimal direct impact on GB consumers as these measures are already in place to a large extent. The costs on suppliers may be higher as they are required to collect and provide extra data.

A brief summary of the costs and benefits of the preferred option is set out in Table 2.

Table 2: Consumer Information	
Costs	Benefits
<p>This measure imposes a small one-off cost to energy suppliers associated with changing promotional material and sending out the concise version of the Consumer Checklist. There may be larger costs associated with data collection and an increased administrative burden associated with the provision of information to regulatory bodies.</p> <p>There is also a one-off cost to Consumer Focus² for compiling and keeping the checklist under review.</p>	<p>There is a direct benefit to consumers who will be able to use their consumption information to take advantage of more suitable tariffs and improve their services as a result of access to information about dispute settlement mechanisms.</p>

Transmission and Distribution Networks

The measures introduce new requirements for full ownership unbundling of transmission, and introduce greater monitoring powers around the continued legal unbundling for distribution.

The network-related objectives of the Third Package are designed to improve competition through better regulation, unbundling and reducing asymmetric information, and improving security of supply by strengthening the incentives for sufficient investment in transmission and distribution capacities.

However, in the area of transmission and distribution networks, the GB gas and electricity arrangements are to a large degree already compliant with the Third Package. One of the key areas we need to address, however, is to provide the legislative framework within which Ofgem can certify transmission systems as meeting the requirements of ownership unbundling. We do not expect the cost of this measure to be significant.

A brief summary of the costs and benefits of the preferred option is set out in Table 3.

² The Government intends to consult on the future of consumer bodies. Should this consultation result in changes to the role of status of Consumer Focus, we would expect this work to be carried out by any successor body.

Table 3: Transmission and Distribution Networks	
Costs	Benefits
<p>This measure imposes legal and administration costs associated with legislation changes and licence modifications to ensure compliance with TSO and DSO unbundling requirements for both Ofgem and the TSOs. There will be administration and legal costs to Ofgem and TSOs associated with the TSO certification process, particularly where derogations are requested. There may be additional costs associated with strengthened information gathering powers for Ofgem enforcement of DSO unbundling articles. There may also be costs to DSOs of ensuring independence of compliance officer.</p>	<p>GB is already compliant to a large degree and we would therefore expect the benefits to be minimal. Full compliance could lead to small gains in terms of more efficient networks (less congestion, more investment), decreased market concentration leading to lower energy prices for consumers, and higher innovation in the energy sector. The likely extent of these benefits is small, as under 10% of GB transmission assets are not already fully ownership unbundled and the European Commission acknowledges that even then the GB system exemptions function reasonably well.</p>

Citiworks Ruling: Third Party Access to Licence Exempt Networks

Following the European Court of Justice (ECJ) ruling on the Citiworks case in May 2008, there is now a requirement to provide for third party access in respect of all transmission and distribution systems. This also applies to licence exempt electricity and gas distribution networks which are required to offer third party access under the Electricity Directive and the Gas Directive. Closed Distribution Systems (licence exempt networks) will continue to be required to provide third party access under the EU's Third Package.

The policy objective is to ensure third party access to licence exempt energy distribution networks. This will ensure energy customers benefit from competition in the energy supply market and ensures the compliance of the GB electricity market with EU law.

A brief summary of the costs and benefits of this preferred option is set out in Table 4.

Table 4: Citiworks Ruling: Third Party Access to Licence Exempt Networks	
Costs	Benefits
The main costs associated with providing third party access to these networks are those associated with metering – either meter provision or ‘deemed’ metering. Costs will vary substantially according to the implementation models chosen.	There will be benefits associated with reductions in energy use, where meters are provided. Switching consumers will benefit from lower energy prices. The evidence is ambiguous on the extent to which these benefits are likely to be achieved.

Gas Storage and LNG Facility Impacts

These measures include a requirement for Storage System Operators (SSOs) to be legally unbundled, for third party access to storage facilities that are technically and / or economically necessary to be strengthened, for all gas storage and LNG operators to be designated, and for more information to be made publically available by gas storage and LNG facility operators.

The measures are intended to have the effect of reducing market power, increasing competition, increasing efficient investment and use of assets, helping to allow gas to flow to where it is needed most, and enhancing security of supply. However, the actual measures are unlikely to have a large impact.

In DECC's consultation on the implementation of the EU Third Package, we considered two options for implementing the key provisions: through the Gas Act 1986 (legislation) or through the introduction of licences for SSOs. The consultation document contained both options. Following the majority view in response to the consultations, DECC has selected to implement the obligations through legislative change.

DECC received little firm evidence in the consultation responses to inform its estimates of the costs and benefits of implementing the Third Package. A qualitative summary of the costs and benefits of the preferred option is set out in Table 5.

Table 5: Gas Storage and LNG Impacts	
Costs	Benefits
There may be small costs associated with unbundling, some costs associated with reduced economies of scope on vertically integrated firms, and costs associated with additional information provision by LNG and storage facilities.	The benefits specifically arising from GB implementing the gas market measures will be: benefits to consumers from more competitive pricing and increased security of supply; benefits to storage users from information transparency and non-discriminatory allocations; and benefits

Table 5: Gas Storage and LNG Impacts	
Ofgem may experience small additional costs due to enforcement.	to investors arising from greater regulatory certainty.

National Regulatory Authority

The Third Package includes a number of measures to enhance the independence, impartiality and transparency of the national regulatory authorities. These measures include requirements on Member States to ensure that staff employed by national regulators are able to act independently of market interest. Compared to the Second Package, the Directives require an expansion to the regulator's duties, for example in relation to cross border issues, and a requirement to ensure that they have the necessary powers to carry out their duties.

GB has in place many of the requirements in the Directives in relation to independence and transparency, although some of these requirements do not go far enough (please see section on Licence Modification Appeals below) .

Although it is difficult to put a monetary value on the benefits associated with these measures, we would expect the intangible benefits arising from these measures to be an increase in the integrity of the regulator and a better functioning of the EU internal market. This could lead to better market outcomes and overall reduced costs for consumers.

For the reasons set out above, we expect the actual impact of these measures to be small. A brief summary of the costs and benefits of the preferred option is set out in Table 6.

Table 6: National Regulatory Authority	
Costs	Benefits
These measures will increase Ofgem's duties, a number of which are monitoring. There may also be an increase in the administrative costs Ofgem faces, for example through an obligation to report to the Commission and ACER (the Agency for the Co-operation of European Regulators) on its activities. Overall we expect the costs associated with individual measures to be small.	We would expect the intangible benefits arising from these measures to increase the integrity and workings of the regulator, as well as the consistency of regulation in Europe. This should lead to better market outcomes for both industry and consumers.

Licence Modification Appeals

As referred to above, the Third Package gives the National Regulatory Authority numerous regulatory tasks and stipulates that it must have powers to, amongst other matters: take autonomous decisions; implement binding decisions by the European Commission and ACER; and carry out its regulatory tasks in an efficient and expeditious manner. It also requires that Member States ensure that suitable mechanisms are in place under which a party affected by the decision has a right of appeal. Taken together, the Government considers that these requirements mean that the current process for licence modifications must be amended to enable the regulator to carry out its duties.

Under the current system, Ofgem's proposed change or introduction of a standard licence condition can be blocked by 20% of the relevant licensees (measured by number of licence holders or market share). If the proposal is blocked then Ofgem can either re-consult on a modified proposal or refer the proposal to the Competition Commission (CC) for a decision. For conditions specific to one licensee, the licensee must agree to the proposal. Failure to reach agreement with that licensee means that if Ofgem wants to impose the change, it must refer its proposal to the CC for a decision. In considering a reference made to it, the CC investigates whether the licence modification operates or may operate against the public interest.

Our preferred option is the introduction of an appeals system which will enable all directly affected licensees (i.e. those holding the class of licence to which the modification decision relates), all materially affected licensees and Consumer Focus (where consumers are materially affected), to appeal all licence decisions to the CC. The CC will have an adjudicatory function (rather than a full investigatory function), but will have the right to review all relevant aspects of the decision under appeal. Under this option, Ofgem will make a licence modification decision (after the current statutory consultation period). If that decision is to modify a licence condition, a directly affected licence holder, another materially affected licence holder or Consumer Focus (where consumers are materially affected) can, with sufficient grounds, appeal that decision to the CC.

Our final proposal for implementing a licence modification appeals system to meet the Third Package requirements does exceed the minimum requirements of the Directive, in that:

- it applies to all Ofgem licence modifications decisions rather than introducing an appeals system for the implementation of decisions in relation to the regulatory tasks arising from the Third Package only; and
- it extends the right of appeal from directly affected licensees only to other materially affected licensees and Consumer Focus (where consumers are materially affected).

However, we concluded that, were minimum implementation feasible, the resulting costs would be uncertain, and it would likely lead to increased regulatory uncertainty and risk of satellite litigation. In addition, though extending the right of appeals may lead to an increase in the number of appeals (and thereby an increase in costs), we believe that this will deliver a coherent regulatory framework leading to improved decision making and greater regulatory certainty.

A brief summary of the costs and benefits of the preferred option is set out in Table 7.

Table 7: Implementation of Licence Modification Appeals	
Costs	Benefits
<p>Monetised costs include the one-off set-up cost to the CC, and ongoing costs associated with appeals borne by the CC, Ofgem and business. These latter costs depend on the number of appeals per year.</p> <p>Non-monetised costs include costs associated with interested parties giving evidence at each appeal</p>	<p>Monetised benefits include ongoing cost-savings from avoided licence modification references, to the CC, Ofgem and business.</p> <p>Non-monetised benefits include improved quality of decision making; improved efficiency of decision making; increased fairness and competition; increased transparency and accountability; and reduced cost of capital for licensees.</p>

Implementation Costs

There are some additional costs on Government and Ofgem associated with implementation of the Third Package that are not captured elsewhere. These costs are associated with drafting and implementing licence changes. We estimate the costs on Government to be a one-off transitional cost of approximately half a million pounds. Ofgem advise that the one-off cost to them of drafting licence changes is in the region of £150k.

Post Implementation Review

Table 8 below sets out DECC's Post Implementation Review plan for GB implementation of the EU Third Package.

Table 8: Post Implementation Review Plan
<p>Basis of the review: DECC will review its approach to implementation of the Third Package within 5 years, to ensure it still meets the stated policy objectives, and to inform the European Commission's own considerations of the success of the legislative package.</p>
<p>Review approach and rationale: DECC and Ofgem will continue working closely with stakeholders during the implementation phase. Wherever appropriate, DECC may request data from the energy suppliers as further evidence of how the implementation phase is working.</p>
<p>Baseline: The implementation of the Third package formalises or introduces new requirements; the baseline is the position before these policies were introduced or formalised.</p>

Success criteria:

Implementation will be reviewed against the original success criteria, including whether the policy is working on the ground, the costs to business and the benefits to consumers.

Monitoring information arrangements:

The Third Package sets out certain monitoring and enforcement responsibilities for Ofgem. For certain aspects of implementation, Ofgem will provide guidance and update its enforcement guidelines. DECC will continue to work with the regulator to assess the impact of the Third Package measures and to ensure that the framework works efficiently.

Title: Third Package: Transmission and Distribution Networks Lead department or agency: Department of Energy and Climate Change Other departments or agencies:	Impact Assessment (IA)
	IA No: DECC0005
	Date: 14/01/2011
	Stage: Final
	Source of intervention: EU
	Type of measure: Legislation
	Contact for enquiries: Phil.Hicken@decc.gsi.gov.uk Richard.Davies1@decc.gsi.gov.uk

Summary: Intervention and Options

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

Articles 9-11 of the Third Package Electricity and Gas Directives and Article 3 of the Electricity and Gas Regulations introduce new unbundling requirements on transmission system owners (TSOs). These articles affect existing electricity and gas transmission systems, interconnectors, and the new Offshore Transmission Operators (OFTOs). Article 26 of the Directives places further unbundling requirements on Distribution System Operators (DSOs). Provisions are also made for exemptions to be granted to Closed Distribution System (CDS) operators (Article 28).

All Member states have to comply with EU legislation and therefore GB needs to transpose the requirements into UK law.

What are the policy objectives and the intended effects?

The two primary network-related objectives of the Third Package are to:

- (a) Improve market competition through better regulation, unbundling and reducing asymmetric information; and
- (b) Improve security of supply by strengthening the incentives for sufficient investment in transmission and distribution networks.

In the area of transmission and distribution networks the GB gas and electricity arrangements are already largely compliant with the Third Package.

What policy options have been considered? Please justify preferred option (further details in Evidence Base)

The minimum compliance option has been assessed throughout. It represents the Government's preferred option, as it ensures compliance with EU law at minimum cost to Government, regulator and industry.

The preferred option will include the following measures:

- Legislation and licence changes to allow for Ofgem certification of TSOs, including derogations under Article 9. Some modifications might also be required with respect to interconnectors and OFTOs.
- The Ofgem certification process itself, which will apply to all existing TSOs, interconnectors and OFTOs.
- Licence modifications and additional information gathering powers for Ofgem to ensure full compliance with the new requirements.

When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?	Please refer to over-arching IA
Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	No

Ministerial Sign-off For Final stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:



Date: 12/01/2011

Summary: Analysis and Evidence Policy Option 1

Description:

Implement the minimum-compliance option for all measures.

Price Base	PV Base Year	Time Period	Net Benefit (Present Value (PV)) (£m)		
			Low: n/a	High: n/a	Best Estimate: -0.85
COSTS (£m)	Total Transition (Constant Price)	1 Year	Average Annual (excl. Transition) (Constant	Total Cost (Present Value)	
Low	n/a		n/a	n/a	
High	n/a		n/a	n/a	
Best Estimate					
Description and scale of key monetised costs by ‘main affected groups’					
Administration and legal costs to TSOs associated with the TSO certification process, particularly where derogations are requested. Small administrative cost likely to Ofgem but not costed. Certification process has been costed for 25 TSO applications and the expected three derogation applications. Licensees might also experience some administration costs in making an application which might be one to twenty times the application fee costs. These have been included in calculations.					
Other key non-monetised costs by ‘main affected groups’					
Legal and administration costs associated with legislation changes and licence modifications to ensure compliance with TSO and DSO unbundling requirements.					
BENEFITS (£m)	Total Transition (Constant Price)	1 Year	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)	
Low	n/a		n/a	n/a	
High	n/a		n/a	n/a	
Best Estimate			n/a	n/a	
Description and scale of key monetised benefits by ‘main affected groups’					
No monetised benefits expected.					
Other key non-monetised benefits by ‘main affected groups’					
Minimal, as GB is already largely compliant. Full compliance could lead to small gains in terms of more efficient networks (less congestion, more investment), decreased market concentration leading to lower energy prices for consumers, and higher innovation in the energy sector. The likely extent of these benefits is small, as under 10% of GB transmission assets are not already fully ownership unbundled and the EC acknowledges that the GB system exceptions (e.g. electricity transmission in Scotland) function well.					
Key assumptions/sensitivities/risks			Discount rate (%)		

Assumption 1 That no significant adjustments to ownership structures are required.

Assumption 2: Interests of financial investors (including step in rights) are protected by approach to drafting.

Assumption 3: Prohibition on exercise of shareholder rights is dealt with in a proportionate way.

Key risk: That investors are deterred if they are not able to exercise their rights in transmission and distribution businesses in the ways that they would expect.

Impact on admin burden (AB) (£m):			Impact on policy cost savings (£m):	In
New AB: n/a	AB savings:	Net: n/a		no

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?						
From what date will the policy be implemented?		03/03/2011				
Which organisation(s) will enforce the policy?		Ofgem, EC				
What is the annual change in enforcement cost (£m)?		Small administrative costs for Ofgem				
Does enforcement comply with Hampton principles?		Yes				
Does implementation go beyond minimum EU requirements?		No				
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)		Traded:		Non-traded:		
				n/a		
Does the proposal have an impact on competition?		Yes				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?		Costs:		Benefits:		
Annual cost (£m) per organisation (excl. Transition) (Constant Price)		Micro	< 20	Small	Medium	Large
Are any of these organisations exempt?		Yes	Yes	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
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Statutory equality duties³ <u>Statutory Equality Duties Impact Test guidance</u>	No	
Economic impacts		
Competition <u>Competition Assessment Impact Test guidance</u>	Yes	10
Small firms <u>Small Firms Impact Test guidance</u>	No	
Environmental impacts		
Greenhouse gas assessment	No	
Wider environmental issues <u>Wider Environmental Issues Impact Test guidance</u>	No	
Social impacts		
Health and well-being <u>Health and Well-being Impact Test guidance</u>	No	
Human rights <u>Human Rights Impact Test guidance</u>	No	
Justice system <u>Justice Impact Test guidance</u>	No	
Rural proofing <u>Rural Proofing Impact Test guidance</u>	No	
Sustainable development	No	
<u>Sustainable Development Impact Test guidance</u>		

³ Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No	Legislation or publication
.	
	DECC call for evidence: http://www.decc.gov.uk/en/content/cms/consultations/eu_energy_mkt/eu_energy_mkt.aspx
	EC Third Package Impact Assessment: http://ec.europa.eu/energy/gas_electricity/interpretative_notes/doc/2007_09_19_impact_assessment.pdf
	Transmission Price Control Review 2007-12: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=191&refer=Networks/Trans/PriceControls/TPCR4/ConsultationDecisionsResponses
	DECC consultation: http://www.decc.gov.uk/en/content/cms/consultations/imp_eu_third/imp_eu_third.aspx

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y ₀	Y ₁	Y ₂	Y ₃	Y ₄	Y ₅	Y ₆	Y ₇	Y ₈	Y ₉
Transition costs	0.85									
Annual recurring cost	-									
Total annual costs	0.85									
Transition benefits	-									
Annual recurring benefits	-									
Total annual benefits	-									

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

1. Issue

Articles 9-11 of the Third Package Electricity and Gas Directives and Article 3 of the Electricity and Gas Regulations introduce new unbundling requirements on transmission system owners (TSOs). These articles affect existing electricity and gas transmission systems, interconnectors, and the new Offshore Transmission Operators (OFTOs). Article 26 of the Directives places further unbundling requirements on Distribution System Operators (DSOs). Provisions are also made for exemptions to be granted to Closed Distribution System (CDS) operators.

All Member States have to comply with EU legislation and therefore GB needs to transpose the requirements into UK law.

The two primary network-related objectives of the Third Package are to:

- (a) Improve competition through better regulation, unbundling and reducing asymmetric information; and,
- (b) Improve security of supply by strengthening the incentives for sufficient investment in transmission and distribution capacities.

In the area of transmission and distribution networks, the GB gas and electricity arrangements are already largely compliant with the Third Package.

2. Articles and description of options considered

The minimum compliance option has been assessed throughout. It represents the Government's preferred option.

a) Transmission unbundling

The Third Package requires full ownership unbundling of transmission assets. However, article 9 allows for three derogation options:

- (a) The Independent System Operator (ISO) model: where, on 3 September 2009, the transmission system was part of a vertically integrated undertaking (VIU), the Member State may designate an ISO. Such an ISO would act as the system operator and would have, for example, independent responsibility for investment planning and management of third party access. The TSO would provide support, including through finance for investments identified by the ISO.
- (b) The Independent Transmission Operator (ITO) model: where, on 3 September 2009, the transmission system was part of a VIU, the TSO may remain part of the owning company. However, the TSO will need to comply with stringent rules on ring-fencing to ensure that it is completely independent from the rest of the VIU.
- (c) Arrangements providing greater independence than the ITO model: where, on 3 September 2009, the transmission system was part of a VIU and there are arrangements in place that guarantee more effective independence of the TSO than the ITO model, a Member State may decide to apply the ownership unbundling derogation.

There are a number of companies that might seek such derogations:

Scottish TSOs (SPET and SHETL): When the single GB energy market (BETTA) was created Scottish Power and SSE retained ownership of their transmission assets. These vertically integrated companies also own distribution, generation and supply businesses. There are, however, important regulatory safeguards to promote competition and efficient network operation including a single system operator (National Grid) and industry codes, overseen by Ofgem, governing such issues as investment and network access. Having multiple transmission owners provides the regulator with important comparators in agreeing network investment and pricing and a potential competitive element in delivering new infrastructure. Whilst transmission assets could not now be included in vertically integrated ownership structures we do not believe that they have been a barrier to the development of a competitive market.

Interconnector UK (IUK): Although no one has a controlling interest in the company, the unbundling text of the Directives still catches minority shareholders.

Certification

The derogations listed above will be granted by Ofgem, as National Regulatory Authority, but will also have to be approved by the European Commission. They will form part of the **TSO certification process** described in articles 10 and 11 of the Electricity and Gas Directives. Part of the certification process will need to be reflected in legislation with some of the detail included in licences.

The Government's final proposals are that:

- Ofgem will be the certification authority (and NIAUR in Northern Ireland).
- The ITO model will be made available for gas inter-connectors only. The Government's view is that this will provide important flexibility to enable Ofgem and the regulatory authorities in other Member States to arrive at consistent cross-border regulatory arrangements.

TSO certification will be required for existing electricity and gas TSOs, interconnectors and OFTOs.

b) Distribution unbundling

Article 26 of the Electricity and Gas Directives highlights some additional unbundling requirements for Distribution System Operators (DSOs). DECC and Ofgem's analysis together with the responses to the call for evidence suggest that GB is largely compliant in this area.

3. Benefits

a) Transmission unbundling

The EC Impact Assessment (pp. 33-45) highlights the following broad categories of benefits from full ownership unbundling:

- greater investment in the network – e.g. the EC IA finds that in markets with ownership unbundled TSOs, investment in interconnectors as a proportion of congestion revenues is double that in markets without full unbundling (33% compared to 17%), in turn leading to less congestion.

- reduced market concentration – “average market shares of the largest generator were in 2005 in Member States with legal unbundling 73% versus 47.7% in Member States with ownership unbundled TSOs”.
- lower energy prices for domestic and industrial consumers – for industrial consumers “the price difference between the two country samples over the entire period of nine years was thus 9% in favour of Member States with ownership unbundling”; for household electricity users the difference was 24% in favour of Member States with ownership unbundling.
- greater levels of research and innovation in the electricity sector – “while it is difficult to attribute increased research expenditures to single factors, open competitive markets seem to support innovation and research in energy”.

The association between ownership unbundling and these positive outcomes is therefore strong and significant. Caution, however, should be exercised in interpreting these results – whereas the EC Impact Assessment does demonstrate a strong association, it does not conclusively prove a causal link.

Transmission Owner	Regulated Asset Value (RAV), at close 2006/07	Share of total transmission RAV
National Grid Electricity Transmission (NGET)	£5,416m	57.3%
National Grid Gas NTS (NGG)	£2,981m	31.5%
Scottish Power Transmission Ltd (SPTL)	£288m	3.0%
Scottish Hydro Electricity Transmission Ltd (SHETL)	£764m	8.1%

Source: Ofgem Transmission Price Control Review (2007-12)

However, even if GB transmission assets are not fully unbundled the extent to which the UK will benefit from the Third Package is limited by two factors. Firstly, the large majority of transmission assets are unbundled: the entire gas transmission network is fully ownership unbundled and the entire electricity network in England and Wales is ownership unbundled. It is only the Scottish electricity TSOs that are not ownership unbundled, representing less than 10% of the total transmission Regulated Asset Value (RAV). In the case of Scotland, the System Operator function is independent, ensuring access, charging and other activities take place on a non-discriminatory basis.

The effectiveness of the current arrangements in Scotland is also recognised in the EC Impact Assessment (p. 41).

“SP and SSE promote the ISO solution while NG, Ofgem and the UK Department of Trade and Industry express a more reserved position. A common criticism is that the ISO is only a second best solution to ownership unbundling and only functions reasonably well in Scotland because some particularities:

- (i) *The Scottish electricity market is relatively small and largely isolated from the rest of the UK. The grid is therefore relatively easy to manage;*
- (ii) *NG is an experienced, ownership unbundled TSO in the neighbouring area guaranteeing its independence and preventing “cross-border” problems and*

(iii) Ofgem is a strong regulator closely monitoring the relationship between the ISO and the asset owners.”

Having said that, three responses to the call for evidence (from National Grid, one of the Big Six, and an independent DSO) support full unbundling, whereas only SSE and Scottish Power argued in favour of the current system. This suggests that there might be some additional competition gains to be had from full unbundling in the GB market.

In DECC’s consultation on implementation of the EU Third Package, the Government was minded not to make the ITO model available as it may not be compatible with GB market arrangements. The Government’s view was that the ITO model does not guarantee independence as effectively as the arrangements in the GB on-shore system. As noted above, the onshore gas and electricity systems are either fully ownership unbundled or benefit from a separate System Operator function that ensures access, charging and other activities take place on a non-discriminatory basis.

However, consultees have made the case for the ITO model for gas inter-connection. These arguments are based on potentially higher costs of transition to other Third Package compliant models, as well as the need to ensure that regulators in each of the responsible Member States have maximum flexibility to reach agreement and ensure consistent cross-border regulatory arrangements. The Government agrees that there is a case for the ITO model to be available in these circumstances, and proposes to make the ITO model available for gas interconnectors only. Electricity interconnection is fully ownership unbundled.

b) Distribution unbundling

The EC Impact Assessment (pp. 57-58) suggests that “as with TSOs, the more effective unbundling of DSOs would in principle contribute to the creation of a level playing field at the retail level, mainly by eliminating incumbents’ information advantages, preventing cross-subsidies and ensuring fair network access and transparent customer switching procedures... [It] would thus contribute to the contestability of the retail market and thus facilitate market entry by third party suppliers”, leading to lower prices for consumers.

Article 26 of the Electricity and Gas Directives highlights some additional unbundling requirements for Distribution System Operators (DSOs). DECC and Ofgem’s analysis together with the responses to the call for evidence suggest that GB is largely compliant in this area.

4. Costs

a) Transmission unbundling

Implementation costs

These relate to putting in place legal and administration arrangements to implement the Third Package.

There may be some small additional administration costs for Ofgem regarding certifying TSOs in line with the processes set out in the Package, enforcement costs or costs associated with facilitating the consultation of system users. These costs are unlikely to be material, although Ofgem will be in a better position to assess these costs after transposition of the Directive.

There would be additional administration costs to licensees. Application fees for licences, as charged by Ofgem, tend to cost between £350 and £1,050.⁴

In addition to the cost of the licence, licensees might also experience some administration costs in making an application which might be one to twenty times the application fee costs. (This is based on the estimated cost of applying for a gas transporter licence.) Applying these costs to the approximately 25 companies that may require TO certification (including current gas and electricity TOs, interconnectors and OFTOs), would imply an additional administrative burden to the private sector in the range of £17,500 to about £550,000.

For those seeking derogations we expect costs to be higher, potentially in the range of £100k per derogation – a cost broadly equivalent to that assumed for existing OFTOs to engage in the development of the new offshore regime in the March 2009 Offshore Electricity Transmission Impact Assessment. As three TOs are expected to seek derogations, the derogation costs are estimated at £300,000.

Therefore, the total cost of the certification process is estimated at around £850,000.

Enforcement and monitoring cost issues

On transmission ownership unbundling we would expect a low level of enforcement/monitoring post-certification. The areas that could arise are changes in ownership (not strictly enforcement, but will need monitoring) and transmission companies' compliance with undertakings that they give, such as rights in other energy interests. On the latter, we think there will be little or no activity as previous experience has indicated that once the governance and separation is established at the outset, then compliance rates are very high.

Other cost issues

In their response to the call for evidence, SSE suggested that there are potential costs in terms of additional risk and uncertainty for required transmission investments associated with moving towards a different ownership unbundling regime as part of Ofgem's certification process.

However, the evidence of recent European experience in ownership unbundling presented in the EC Impact Assessment suggests that the commercial and investment risks associated with unbundling tend to be overplayed. The EC find (p. 35) that "shareholders have in fact in almost all cases benefited from increasing share prices during and after the ownership restructuring". Moreover, there is "some evidence against the common view that the predictable revenue stream of the network business makes a vertically integrated companies [sic] less risky than a company without network assets, allegedly giving it cheaper access to investment capital".

Overall, the Commission do not find any negative impact on security of supply as a result of reduced network investment likely to arise from the proposed measures. It is worth restating the caveat that this conclusion is reached without having established a robust counterfactual – in other words, we do not know whether these companies would have done even better in terms of their value and credit-worthiness in the absence of unbundling.

⁴ <http://www.ofgem.gov.uk/Licensing/Work/Documents1/SupplementaryAppendix2-Guidanceforgasnd0electricityapplications.pdf>.

b) Distribution unbundling

As distribution unbundling is an existing requirement and has already been implemented, there should not be any additional costs. All companies are compliant so we do not envisage any monitoring or enforcement activity.

5. Competition impact

The Office of Fair Trading's guidance, "Completing competition assessments in impact assessments", suggests answering the following four questions to determine whether the proposal will have a significant impact on competition.⁵ Will the proposal:

- Directly limit the number or range of suppliers?
- Indirectly limit the number or range of suppliers?
- Limit the ability of suppliers to compete?
- Reduce suppliers' incentives to compete vigorously?

The unbundling proposals for transmission and distribution systems in the EU Third Package, does not limit the number of suppliers, limit the ability of suppliers to compete nor reduce their incentives to compete vigorously.

As the large majority of transmission assets are already unbundled, the extent to which the UK can benefit is limited. It is only the Scottish electricity TSOs that are not ownership unbundled, representing less than 10% of the total transmission Regulated Asset Value.

However, three responses to the call for evidence (from National Grid, one of the Big Six, and an independent DSO) support full transmission unbundling, whereas only SSE and Scottish Power argued in favour of the current system. This suggests that there might be some additional competition gains to be had from full unbundling in the GB market.

The EC Impact Assessment (pp. 57-58) suggests that like TSOs, the more effective unbundling of DSOs could contribute to the creation of a level playing field at the retail level. This would be through eliminating incumbents' information advantages, preventing cross-subsidies and ensuring fair network access and transparent customer switching procedure. This would contribute to the contestability of the retail market and thus enable market entry by third party suppliers, leading to lower prices for consumers.

6. Human Rights

To the extent that human rights may be engaged, we consider the approach to be compatible with the Human Rights Act 1998.

7. Risks

A number of call for evidence responses raise concerns about the fact that the Third Package precludes undertakings with ownership of energy supply, generation or production from owning

⁵ http://www.offt.gov.uk/shared_offt/reports/comp_policy/oft876.pdf

shares in an unbundled TSO and any subsequent voting rights associated with that share ownership.

National Grid, for example, “is particularly concerned about the efficacy, costs and complexity of any rules which might be used to implement the unbundling regime, in the manner contemplated”, by the Commission. “It is not clear how shareholders of network operators might be identified as being, for example, suppliers, or how they might be prohibited from voting. It would seem [...] sub-optimal to impose obligations on such shareholders and is not in keeping with the transmission independence which already exists in GB”.

We plan to implement these provisions in a way that is as light touch as possible. Please refer to Chapter 3 in the Government Response.