Ofgem's Review of the Energy Supply Licence

Compliance with the Industry Codes and Agreements

A paper for the Industry Codes Working Group
from npower and EDF Energy

1. Introduction

1.1 The purpose of this paper is to provide Ofgem and members of the Industry Codes Working Group with a proposed model for managing supplier compliance with industry codes and agreements, having regard to one of Ofgem's key principles for the supply licence review, namely that**:**

- Licence conditions that relate to compliance with industry codes and agreements are only likely to be necesssary if [those instruments] do not themselves contain adequate sanctions for suppliers who breach them.

1.2 In preparing the paper, npower and EDF Energy have aimed for a model that can strike an appropriate balance between self-regulation and formal regulation, consistent with the principles of best regulatory practice which Ofgem is legally required to take into account in carrying out its functions.

1.3 A key criterion should be the need to avoid, or at least limit, the need for new or amended legislation (for example, by use of the Regulatory Reform Act 2001) as this would inevitably reduce the industry's and Ofgem's degree of control over the implementation process, and so introduce complexities and delay.

1.4 As far as possible, therefore, the efficient introduction of any change should be able to be achieved within the limits of the supply licence review process.

1.5 The analysis and conclusions set out below are broadly supported by Centrica, Scottish and Southern Energy, Scottish Power, and E.ON.

2. Essential background

2.1 The codes and agreements with which the Ofgem review is concerned do not form a homogeneous group, and it is important to recognise differences between them. The most significant distinction is between those instruments which are contractual in nature (such as the MRA, SPAA, or BSC) and those which are not (such as the Distribution and Grid Codes).

2.2 However, this distinction may be less important than it appears, since the core industry documents form a mutually reinforcing framework of obligations for the electricity and gas industries, and even non-contractual documents may be made binding where compliance with them is required under a separate contract (for example, compliance with the Distribution Code as a standard condition of the distribution use of system agreement).

2.3 What also unites the codes and agreements is the common requirement in most cases for suppliers to 'become a party to and comply with' the provisions of these documents. It is not clear, however, that Ofgem has ever undertaken any thorough-going policy analysis of the need for 'compliance' obligations of this kind. Instead, such obligations appear to have been extended, by analogy across a number of documents, from a starting point which amounted to a safety-first approach in the context of fundamental new industry arrangements.

2.4 It therefore seems right that the need for these obligations should be re-assessed, in particular since Ofgem's potential for regulatory intervention on the basis of the 'compliance' obligations, in the context of a mature and fully competitive supply market, is greater than that of most comparable regulators.

3. Duplication of enforcement process

3.1 An undesirable effect of the current arrangements is the creation, in the case of most codes and agreements, of a form of double jeopardy. This is because their provisions can be enforced both by other parties exercising their contractual rights under the relevant instrument, and by Ofgem exercising its regulatory functions under the licence.

3.2 Since these two mechanisms are not legally dependent on each other, there is nothing to prevent both of them from being used in relation to the same event of compliance default. As a result, (i) a party may be penalised twice for the same breach of compliance (once under the industry agreement and once under the regulatory framework); and (ii) different enforcement processes may also give rise to different outcomes in relation to the same event.

3.3 Such duplication of the available processes for enforcing code obligations, with those two inevitable consequences, is fundamentally undesirable as a matter of legal principle. In addition, in more practical terms, it must also add further complexity and risk to participants in the market, which is equally undesirable. The existence of more than one enforcement mechanism encourages debates about the proper allocation of disputes and complaints, is a potential vehicle for delay, and undermines the need for clear lines of responsibility.

4. Contractual enforcement preferred

4.1 All of the above downsides would require some high-level, overriding policy justification that is not evident in the existing code arrangements. Both legal principle and common sense suggest (i) that it would be preferable to develop for each core industry document a single clear process leading to a single clear determination, and (ii) that the process itself should be a contractual process incorporated under the relevant document.

4.2 The reason for aiming to rely as much as possible on contractual enforcement rather than regulatory enforcement is that, given a choice, most complainant parties will have strong reasons for preferring to bring an allegation about the breach of a code or agreement in a contractual forum, since the basic remedy for breach of contract is payment of damages calculated so as to compensate affected parties for their losses.

4.3 In contrast, enforcement action by Ofgem does not establish a right to monetary compensation, and at most gives rise only to a requirement to pay a financial penalty. This is paid to the Treasury and hence, while punishing the party in breach, does nothing to recompense the parties or consumers for whom that breach can be shown to have caused loss.

4.4 At present, however, with one or two rudimentary exceptions, the core industry documents do not include the kind of intra-party compensation regimes that would normally be present in major commercial agreements. It seems likely that provisions for the consequences of compliance breach are significantly under-developed in most of the codes precisely because of the perception that Ofgem functions as principal enforcement body and that its engagement in issues of compliance removes the need for the codes themselves to develop a more thorough contractual approach to dealing with events of default.

4.5 There is therefore a cause-and-effect relationship between (i) the current state of the internal enforcement provisions under each code and (ii) the existence of a 'compliance' obligation under the licence which confers an external power of enforcement on Ofgem. It is strongly arguable that if Ofgem had no such formal role, or if that role were to be substantially more limited than at present, then there would automatically be the appropriate commercial incentive for the codes to be developed so as to deal more thoroughly and authoritatively with events of default and sanctions for breach.

5. Single mechanism for default events

5.1 Taken together, all of the above observations can be summarised as follows**:**

- in the case of each core document, there should be a single mechanism for managing events of compliance default;
- that mechanism should be based on an agreed (i.e. contractual) process for resolving incidents of non-compliance and for determining the appropriate sanction for breach, rather than on a licence requirement for compliance enforced by Ofgem using regulatory powers; and
- it should in consequence favour contractual compensation over financial penalties as a mechanism for putting right the effects of a breach.

5.2 The above changes would be entirely consistent with all the principles of good regulation, now enshrined in law by the Energy Act 2004.

6. Ofgem should have a long-stop role

6.1 Assuming that the governing bodies of all the core industry documents are (or could be) capable of carrying out enforcement-related contractual functions to a high standard, the question arises whether, if the 'compliance' obligation was removed from the licence in relation to all the codes and agreements, the consequent total loss of Ofgem's enforcement and penalty-imposing powers in relation to breaches of these documents would be likely to be detrimental to consumers or to other market participants.

6.2 We acknowledge that the potential for such detriment is, at least, a possibility under the proposed changes and that, in any event, exclusion of Ofgem from any formal enforcement role whatever in this area may not be consistent with a full and proper discharge of Ofgem's statutory duties. The appropriate, and proportionate, response would therefore be to recognise in advance those areas of the codes and agreements that are expected to be of specific concern to Ofgem as a consumer protection regulator.

6.3 On that basis, it would then be prudent to incorporate a long-stop role for Ofgem into any restructuring of the enforcement arrangements for the core industry documents, in respect of such areas. The proposed compliance model would therefore incorporate the following key features**:**

6.4 **Predetermined areas:** Ofgem's enforcement role in relation to major industry codes and agreements would be restricted to a small number of predetermined areas of the documents considered to be of particular interest to Ofgem from a regulatory perspective by reason of their 'customer facing' nature, or because of other particularly sensitive considerations, such as security of supply, public safety, or environmental impact.

6.5 We believe that the task of identifying the appropriate areas of the documents requiring to be highlighted under this approach, if conducted at a suitably high level, should not be difficult to achieve. And the legal mechanism for doing so under the licence could be flexible, so that the predetermined areas and the obligations or requirements arising under them could be removed, added to, or varied over time if necessary.

6.6 **Enforcement by invitation:** In respect of such predetermined areas, Ofgem would only be able to take enforcement action in matters of compliance at the express invitation of the governing body of the relevant document, once all internal compliance arrangements had been exhausted and the body considered that further action was required of a kind beyond its own powers and remit.

6.7 The nearest model for this approach, which would effectively delimit Ofgem's powers to pursuing enforcement action only when invited to do so by the industry itself, are the current governance arrangements for the City Code on Takeovers and Mergers. A key feature of these arrangements is the statutory endorsement of the Code (under section 143 of the Financial Services and Markets Act 2000) by the Financial Services Authority (FSA).

6.8 The effect of such endorsement is to enable the Code Panel to ask the FSA to take enforcement action, under the parent Act, against any company which contravenes the Code or a Panel ruling pursuant to it. At that point (but not before) the full array of the FSA's enforcement powers may be activated.

6.9 An approach based on these arrangements would have the particular merit of allowing the industry to retain all powers of policing and enforcement under the core documents in its own hands, within a contractual process, until such time as regulatory action was considered necessary for some exceptional reason. This would encourage code bodies to 'walk tall' in the exercise of

their own responsibilities, which could include rights of disciplinary action, such as by way of a private reprimand or public censure, while preserving an appropriate long-stop role for Ofgem where the sensitivity or severity of the circumstances clearly calls for this.

7. Illustrative legal drafting

7.1 As noted in the introduction, any need for new primary legislation to give effect to the particular outcomes of the supply licence review could be problematic. However, although the City Code arrangements are backed by statute, it is not clear in the energy sector that a compliance model combining the key concepts of 'predetermined areas' and 'enforcement by invitation' would require any amendment of the gas and electricity legislation. Attachment 1 therefore sets out some legal drafting to illustrate how the model might be given effect via a single, and relatively simple, licence condition.

8. Conclusions

8.1 The model advocated in this paper for managing compliance with core industry documents enshrines the principle of Ofgem acting as enforcer of last resort at the request of the industry, but not otherwise, and only in respect of certain predetermined matters that are expected to be of specific interest to Ofgem in relation to its statutory duties.

8.2 It is accepted that a more tightly focused specification of Ofgem's enforcement role, of the kind now proposed, would be dependent on**:**

- the compliance arrangements within the codes and agreements being developed to include (where they do not already do so) progressive, proportionate sanctions and clear trigger points within an escalation process that provides a more robust contractual approach to dealing with events of compliance default; and

- assurance that the code (etc) governing bodies, going forward, have sufficient independence, skills, and expertise to carry out compliance and enforcement functions on a regular basis and to a high standard (there is no reason, in principle, why certain bodies could not be responsible for overseeing enforcement of more than one code).

8.3 The authors consider that this model strikes the appropriate balance between self-regulation and formal regulation, consistent with the declared agenda for Ofgem's supply licence review. They therefore invite the Industry Codes Working Group to adopt this paper and its conclusions as representing, in principle, the preferred basis on which to proceed.

Attachment 1: Illustrative drafting

- **The legal drafting set out below is intended to illustrate how the compliance model proposed in the main paper – with Ofgem acting as enforcer of last resort at the request of the industry, but not otherwise, and only in respect of certain predetermined matters – could be given effect through a single new condition in the supply licence. For convenience, this drafting applies to the electricity sector only. However, it would be equally applicable to the gas sector and also, in principle, to other categories of licence, such as generation and shipping.**

New Condition XX: Compliance with Relevant Instruments

1. The licensee must at all times be a party to each relevant instrument.

2. This paragraph applies where a relevant instrument in relation to which the licensee holds rights of amendment requires to be modified (a 'consequential change') in order to give full and timely effect to the modification of another relevant instrument.

3. Where paragraph 2 applies, the licensee must, in accordance with such procedures as are applicable under or in relation to the relevant instrument to which the consequential change applies, take all reasonable steps to secure and implement that change and not take any steps to prevent or unduly delay it.

4. Paragraph 3 is without prejudice to any rights of approval, veto or direction which the Authority may have in respect of proposed changes to relevant instruments.

5. The licensee must act in relation to each relevant instrument so as to ensure that at no time do both of the following occur**:**

   (a) the licensee is or has been in contravention of a specified provision of that instrument, and

   (b) the body responsible for the governance of that instrument has declared the licensee to be in serious regulatory breach in respect of that contravention.

6. For the purposes of paragraph 5, a failure to comply with a requirement imposed, or a ruling given, under a specified provision is to be treated as a failure to comply with the specified provision under which that requirement was imposed or that ruling was given.

7. If a specified provision of a relevant instrument is modified, paragraphs 5 and 6 apply to it as modified.

8. A decision specifying a provision of a relevant instrument may only be made, varied, or revoked in accordance with such procedures for modifying that instrument as are applicable under or in relation to it.

9. In this condition**:**

‘relevant instrument’ means any of**:**

(a) the Balancing and Settlement Code;
(b) the Connection and Use of System Code;
(c) the Distribution Code;
(d) the Distribution Connection and Use of System Agreement;
(e) the Grid Code; and
(f) the Master Registration Agreement,

in each case, insofar as applicable to the licensee;

and, in relation to any relevant instrument**:**

‘serious regulatory breach’ means a contravention of that instrument that has been declared as such, in accordance with the provisions of the instrument, by notice to both the Authority and the licensee; and

‘specified provision’ means any provision of that instrument which is specified therein as an obligation or requirement in respect of which the licensee’s compliance is enforceable by the Authority in accordance with this condition.

Note: On a rough estimate, the above draft condition would have the effect of shortening the current electricity supply licence by about 16 pages.