

Industry Codes Compliance Review Consultation

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Target audience: This document will be of interest to all industry participants, licensees and consumer groups

Overview:

The GB gas and electricity sector has a number of regulated contractual codes and agreements which form the framework for its competitive markets. These have been developed over a number of years. The Industry Code Compliance Review (ICCR) will examine the appropriate roles for regulatory enforcement and self-governance of these regulated codes and agreements and will consider both compliance and change control arrangements. This Review will build on the work of the Supply Licence Review which looked at a number of these issues.

This consultation document sets out a number of key issues and seeks views on the objectives and principles of the ICCR. It also asks what priority should be placed on the work and the reasoning behind these views.

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Context

This document forms part of Ofgem's work to evaluate its interface with the regulated contracts and agreements which underpin the operation of the electricity and gas sectors of Britain. Ofgem's principal statutory objective is to protect the interests of consumers. In doing so, Ofgem must have regard to the better regulation principles which require that measures are transparent, accountable, proportionate consistent and targeted only at cases in which action is needed. This document sets out a number of options which may better achieve these objectives by reviewing Ofgem's involvement in the enforcement of regulated contracts.

Some of these issues were evaluated under the Supply Licence Review, but it was considered that as their implications extended to other licences, the issues should be reviewed in a more comprehensive way. Ofgem has initiated the ICCR for this purpose.

Associated Documents

Independent Regulators – October 2003 - Better Regulation Task Force

Regulation – Less is More (reducing burdens, improving outcomes) - March 2005 - Better Regulation Task Force

Reducing Administrative Burdens: effective inspection and enforcement – Philip Hampton - March 2005 - HM Treasury

Reviewing the gas and electricity supply standard licence conditions – A consultation Document – Ofgem 51/05

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10280_5105.pdf

Making Markets Work for Consumers: Ofgem's approach to securing compliance with supply licence obligations and consumer protection legislation. July 2003

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/4035_Final_strategy_consultation_July_03.pdf

Table of Contents

Summary	1
1. Background	3
Self-governance	5
2. Framework for ICCR	7
Objectives	7
Principles of the ICCR	7
Requirements	8
3. Options for Development	9
Option 1 Maintain the current arrangements	9
Option 2 Maintain the current arrangements but with guidance from Ofgem on its enforcement policy	9
Option 3 Retain similar obligations, but with a different test for non-compliance	10
Option 4 Retain the current obligations, but only in relation to specific sections and clauses	10
Option 5 Industry Self-governance of Codes	11
Coterminous Modification Governance and Enforcement	11
4. Timing and Priority	13
5. The Way Forward	14
Approach	14
Deliverables	14
Appendices	15
Appendix 1- Codes and Agreements, their function and suitability for review	16
Appendix 2 - Consultation Response and Questions	21
Appendix 3 – The Authority’s Powers and Duties	24
Appendix 4 - Glossary	26
Appendix 5 - Feedback Questionnaire	27

Summary

Companies participating in the GB electricity and gas sectors are generally licensed by Ofgem according to the activities they undertake. Licence categories in the electricity sector include generation, transmission, distribution, supply, and interconnector, whilst those in the gas sector include shipper, transporter, supplier and interconnector. The licences contain a number of conditions which the licensee must comply with. Ofgem can investigate if it has cause to believe a company is failing to comply with a licence condition. Such investigations could result in enforcement actions including the imposition of a financial penalty for licence breach.

Usually, a licence will include a provision requiring the licensee to accede to and comply with one or more of the Regulated Codes and agreements¹ which cover the commercial and operational aspects of the electricity and gas markets (such as the Balancing and Settlement Code (BSC), Supply Point Administration Agreement (SPAA), etc).

Licence conditions requiring companies to comply with all the provisions of a particular Code can expose the licensee to the risk of enforcement action in the event of breach of any clause of the Code or even a subsidiary document. Some of these Codes contain clauses on operational matters, a breach of which may have no material impact and which may not be suitable for enforcement by Ofgem. Despite the publication in 2003 of principles (as part of a supplier consultation document) which set out when Ofgem are likely to pursue enforcement action, it has been suggested by some parties that the current framework poses an element of Regulatory uncertainty and risk to them.

Consistent with the principles of better regulation, Ofgem is committed to withdrawing from Regulation² where alternative compliance arrangements are in place sufficient to protect customers' interests and our involvement would not be proportionate. As such Ofgem considers it appropriate to examine the extent to which we can rely on Self-governance by industry in the context of the enforcement of the Codes.

The following explains the work we intend to undertake with interested parties and which will culminate in a conclusions paper. We have set out what we hope to achieve as a result of the ICCR, the potential scope of the project, and our perception of the issues and risks associated with it.

¹ For the purposes of this document the term 'Code' will be used to refer to industry Codes and agreements that fall within Ofgem's remit.

² For the purposes of this document Regulation is used with a capital letter to signify regulation by the Authority (Ofgem), notably in its enforcement activities. Self-governance with a capital letter signifies arrangements where the parties to the Code enforce compliance by means of incentives and sanctions for Code breaches, up to and including termination from the Code.

A number of potential options for development have been identified. These include:

- Do nothing - to leave the arrangements broadly as at present if an overall benefit in doing further work cannot be identified,
- Develop our current enforcement policy principles,
- Change the licence conditions so that the compliance provisions are re-stated,
- Consider the structure of the Codes with a view to identifying key sections and clauses Ofgem needs to be able to enforce, leaving the remaining parts enforced by Self-governance, and
- Consider a regime where Self-governance ensures Code compliance without any Regulatory enforcement.

Over the summer we will convene an industry seminar to discuss these issues in advance of the closing date for responses to this document.

1. Background

1.1. The Codes in place today were introduced in response to a number of issues specific to the energy market and network arrangements which preceded them. Because Codes were developed at different times in response to different industry structures they contain different governance arrangements and objectives. This has led to significant differences between the Codes in terms of their structure, content and enforcement regime. There are a number of examples including:

- **The Balancing and Settlement Code (BSC)** - The balancing arrangements in place in England and Wales prior to the existence of the BSC (known as 'the Pool') were perceived to have failed to react quickly enough to change, whilst concern existed over the effectiveness of the arrangements for bidding and price setting, as well as other market-related imperfections. The BSC was the primary document that brought in the New Electricity Trading Arrangements in 2001. These arrangements were extended to Scotland in 2005.
- **The Connection and Use of System Code (CUSC)** - The MCUSA, which preceded the CUSC, did not enable the industry to bring about changes to the network access arrangements which were important if the potential benefits offered by the New Electricity Trading Arrangements were to be fully realised.
- **The Supply Point Administration Agreement (SPAA)** manages the processes between suppliers and distribution companies to enable suppliers to transfer customers. The arrangements available at the time were not suited to dealing with the task of establishing coherent meter point administration and customer transfer processes.

1.2. The Codes share an important feature which provides clear benefit to the participants: the provision of a flexible governance structure to enable the Codes to respond to changing circumstances allowing appropriate changes to be developed and implemented. The Codes enable parties (and in some cases, energywatch) to raise a proposal to change them, for that change to be assessed and developed, and for a decision to be taken by either Ofgem or the industry. By responding to change the Codes provide a key role in ensuring continuing effective functioning of the market.

1.3. The requirement for the establishment of Codes arises in a number of licences where certain licensees are required to ensure that these contracts are developed and maintained to achieve market and efficiency objectives. In the majority of cases the licences also require parties to accede and comply with the Codes, although this requirement is phrased in varying ways. Some of this variation is attributable to the fact that the Codes have been put in place over a period of time and incremental developments have occurred. Some differences may be due to the practical realities of the industry structures which the Codes govern.

1.4. The Supply Licence Review examined the requirement for suppliers to comply with Codes via licence obligations. A number of meetings were held with representatives of the supplier community. The view was expressed by some

suppliers that the current enforcement framework poses an element of Regulatory uncertainty which in turn presented a risk for the companies involved. Ofgem agreed during those meetings that Regulatory risk was not something which should exist without good reason. We committed to trying to ensure that the Regulatory risk experienced in the market was appropriate and that we understood the consequential impact such risk can have on participants, new entrants, competition and consumers. The extent and nature of the Regulatory risk involved has not been quantified by the industry to date. Ofgem notes how Self-governance may not always reduce the risk exposure of parties with compliance obligations. Ofgem notes that some respondents to its recent Simplified P2/5 Regulation Arrangements consultation have reservations about Self-governance because of concerns about the possible risk of an inappropriate transfer of Regulatory risk.

1.5. The Supply Licence Review also considered whether Code compliance could be successfully administered through Self-governance. Ofgem and industry parties considered Code compliance obligations in the Supply Licence and the role of Ofgem in enforcing the relevant Codes. This work has thrown up critical interdependencies with other licences (which contain Code compliance obligations similar those seen in the Supply Licence), and broader questions about the best way to ensure compliance with the Codes and agreements. As a result, Ofgem has committed to carrying out a wider review of the requirements for compliance with the Codes within all the licences. The Industry Code Compliance Review (ICCR) will require Ofgem and the industry to:

- Review the relevant compliance obligations within each of the licences,
- Examine the Codes and agreements listed in Appendix 1,
- Consider the need for Regulatory involvement in achieving compliance, and
- Determine the appropriate level and manner of Regulation.

1.6. Ofgem suggests that the Codes which could be covered by the ICCR include the BSC, UNC, SPAA, MRA, Grid Code, Distribution Code, CUSC and STC. A summary of the history, function and suitability for review of these documents can be found in Appendix 1.

1.7. The ICCR project may also require a review of the governance arrangements associated with the various Codes.

1.8. There is a wide spectrum of views as to the extent of the role that Ofgem should have in relation to the enforcement of the Codes, or, to put it the other way, the extent to which compliance should be Self-governed. The SLR Workgroup, for example, concluded that it was appropriate for Ofgem to retain a role in relation to enforcement-related appeals and as an enforcer of last resort. The considerations behind these views included:

- a. Ofgem's statutory duty to have regard to best Regulatory practice;
- b. Ofgem's other statutory duties, particularly its principal objective of consumer protection;

- c. the five principles of the SLR published by Ofgem in the SLR Way Forward Document (August 2005) - in particular, Principle 3, which states that "Licence conditions that relate to compliance with Codes are only likely to be necessary if they do not themselves contain adequate sanctions for suppliers who breach them";
- d. some licensees' preference for Self-governance (or contractual enforcement) so far as possible - and the wish to avoid the threat of Regulatory intervention;
- e. licensees' wish not to be exposed to the "double jeopardy" of contractual enforcement and that of the Regulator;
- f. the concern to provide greater clarity and consistency as to when enforcement action will be taken, and the relative importance of this compared with any achievable reduction in the level of Regulation;
- g. the extent of the harm (including harm to consumers) that may be caused by participants' failure to comply with Codes;
- h. the extent to which Codes do (or can be made to) secure compliance without Regulatory intervention;
- i. the costs and risks associated with putting in place adequate mechanisms for enforcement that do not rely on routine intervention by Ofgem;
- j. the extent to which Codes do (or can be made to), or should, provide remedies for persons (including other participants and consumers) where a participant fails to comply with their terms;
- k. the extent (if any) to which Self-governance can reduce the Regulatory burden;
- l. the recognition by some licensees that enforcement by Ofgem may help to ensure an inclusive and fair environment for participants; and
- m. the recognition that there will need to be an overarching Regulatory supervision, in respect of appeals and last resort intervention.

Self-governance

1.9. Ofgem is concerned to ensure that it responds properly to its statutory duty in relation to best regulatory practice. This needs, of course, to be set against our other statutory duties, and in particular the importance of ensuring that any enforcement regime - and Ofgem's role (if any) within it - is sufficient to secure the fulfilment of those duties and ultimately the proper protection of consumers and the competitive market. Judgements will need to be made in balancing these various duties and risks.

1.10. Key to this balance, and arguably the principal consideration in assessing any proposed changes, is that any enforcement mechanism must be adequate to secure material compliance with the Codes, such that the operation of the market and the interests of consumers are protected.

1.11. This requires not only that the mechanisms are in place to provide adequate deterrence but also that those mechanisms and their associated procedures are operated effectively. For example, the sanctions must be applied in a fair and consistent way; and the mechanisms and procedures for enforcement operated in an open, transparent and consistent manner. Without suitable structures and safeguards, there is a real risk of introducing greater uncertainty and inconsistency.

1.12. Another important aspect in relation to reliance on Self-governance is the adequacy and effectiveness of competition law.

1.13. If Self-governance is developed and proves not to be entirely satisfactory, Ofgem may feel it necessary to include more detailed provisions in the licences themselves in order to ensure that it is able to achieve sufficient control to properly fulfil its statutory obligations.

1.14. The extent (if any) to which Ofgem would have a role in policing the operation of any Self-governance system, and whether it would have a power and/or duty to intervene in certain cases needs to be considered. In assessing the merits of any Self-governance option, regard should be had to the potential for additional complexity and administrative burden involved in a multi-layered system of enforcement.

1.15. Some licensees might prefer Self-governance to avoid the threat of Regulatory sanctions. The obvious corollary is that there may be a presumption that Self-governance would inevitably lead to less onerous penalties, and thus perhaps less effective deterrence. So, how important is it that Codes are complied with (and the answer is likely to vary depending on the Code obligation in question), and how big a deterrent is needed to ensure compliance?

1.16. If there are conclusions that the possibility of imposing punitive remedies is essential to effective deterrence, appropriate mechanisms would have to be developed to achieve this.

1.17. Whether any enforcement mechanism would also have to be structured so as to provide a remedy for anyone who suffers loss as a result of non-compliance is at this stage unclear, but this may be difficult to achieve in respect of third parties, including consumers.

1.18. The Codes currently operate varying degrees of Self-governance. In some Codes the incentive and sanction regimes for non-compliance with specific aspects are well developed and in regular use.

1.19. If Self-governance were to be more widely applied, we would need to look at whether the existing governance structures were sufficiently robust to deliver the necessary assurance.

2. Framework for ICCR

Question 1: Are the objectives and the principles of this Review the right ones?

Question 2: The nature and extent of the Regulatory burden has not been clearly articulated by the industry. Given that Ofgem has undertaken very few enforcement actions for breach of Codes, are the risks posed not theoretical rather than practical?

Question 3: What is the nature and extent of the Regulatory risk faced by parties - What is the estimated cost to businesses?

Objectives

2.1. The objectives of the ICCR are to:

- Quantify the Regulatory burden posed by the current enforcement regime and to assess whether change would be appropriate.
- Assess, having regard to the principles set out below, the benefits, efficiencies, costs, risks, practical issues and other consequences associated with the various options and mechanisms for enforcement of compliance with the Codes, including any such further options as are identified in the course of the ICCR,
- Consider what action (if any) should be taken in response to the findings of the quantification and assessment, taking into account the potential benefits, costs and risks of such action in the context of the existing Regulatory regime and the need for any changes to be consistent with the principles of best Regulatory practice, and
- Develop an appropriate strategy through which to implement any actions identified.

Principles of the ICCR

2.2. As part of our statutory duties Ofgem are required to have regard to best Regulatory practice and that our Regulatory activities are transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed. Compliance with the Codes can be achieved by either Regulatory or Self-governance arrangements, or by both. For instance, compliance is currently achieved in the Codes by means of commercial incentives and/or penalties (including ultimately termination from the Code) administered by the governing Panels as well as the threat of Regulatory action for licence breach. In principle the compliance arrangements must be:-

- Consistent with the discharge by the Authority of its statutory duties, in order to achieve its principal objective to protect consumers;
- Able to provide enforcement mechanisms that are sufficient to secure material compliance with the Codes, including deterring any breaches of the Codes that may have a detrimental effect on consumers or other market participants or may undermine the effective functioning of the market arrangements which underpin the Codes;

- Proportionate to the potential impact of the relevant Code breaches, and
- Targeted at instances where enforcement action is reasonably required;
- Able to ensure that compliance with the Codes can, and will, be enforced effectively, consistently and transparently.

Requirements

2.3. The ICCR will:

1. Examine the Codes and agreements set out in Appendix 1 and review the relevant compliance obligations within each of the licences and the Codes,
2. Examine the extent of the Regulatory burden posed by the current regime and to consider whether it is appropriate,
3. Analyse the advantages and deficiencies of the existing enforcement regime, including considering the pros and cons of standardisation of enforcement mechanisms and the relationship between enforcement and governance arrangements,
4. Identify the potential enforcement options in respect of each of the Codes,
5. Consider in detail how those options could be implemented and the costs and risks associated with that implementation, and
6. Assess the benefits, efficiencies, costs, risks, practical issues and other consequences associated with each of the various options.

3. Options for Development

Question 1: Which of the options set out below has the most merit?

Question 2: Should options 1 to 3 be considered and developed before options 4 and 5?

Question 3: To what extent is it possible and desirable for industry to make progress on Option 4 (and to some extent option 5) outside the framework of the ICCR?

Question 4: Do you have a view on whether Regulatory enforcement and Code modification decision making should be coterminous?

3.1. The ICCR aims to identify a suitable method for achieving the objectives stated in section two. A number of potential options could be developed within the scope of the Review. In the initial stages of the project Ofgem intends to analyse each of these options so that, if appropriate, they can later be assessed via an Impact Assessment. At this stage Ofgem invites parties to consider which if any of the options set out below is most likely to provide an appropriate means through which to achieve the objectives of the project.

Option 1 Maintain the current arrangements

3.2. This option would mean no change. Whilst industry responses on the Supply Licence Review suggest that improvements should be made, it is conceivable that the time and effort involved would outweigh the benefit. Given that Regulatory enforcement has been used rarely, and only in cases where serious breach had occurred, the potential gains associated with any different regime will need to be carefully evaluated and weighed against the costs of implementing the changes and any ongoing costs of administering revised arrangements.

3.3. The licence requirements for each Code and the Codes themselves have different characteristics and it may be that certain Codes and their related licence conditions would not benefit from further work on compliance issues.

Option 2 Maintain the current arrangements but with guidance from Ofgem on its enforcement policy

3.4. Under this option Ofgem would enforce serious breaches of the Codes through the licence but in the interests of transparency would publish guidance or principles on its enforcement policy. These could acknowledge the need to take into account Self-governance enforcement that may be in progress.

3.5. The Supply Licence Review identified this as an option and proposals were made for guidance building on Ofgem's existing principles of enforcement developed in 2003. This work could be re-visited under this option.

Option 3 Retain similar obligations, but with a different test for non-compliance

3.6. The gas shippers licence condition 3 sets a different requirement to other Codes by not simply requiring Parties to accede and comply with the UNC. Rather, it states that parties must not do anything to knowingly or recklessly jeopardise or compromise the efficient operation of the arrangements. This approach to Code compliance has not found favour when examined by the Supply Licence Review, but there may be a variant or a formulation of words, such as a materiality and persistency test, that captures the right balance.

Option 4 Retain the current obligations, but only in relation to specific sections and clauses

3.7. This approach would introduce a two tier approach to compliance within the Codes by identifying in the first tier sections and clauses that could initially be subject to Self-governance but would be ultimately subject to Regulatory enforcement. The second tier would contain the remaining sections and clauses and would only be subject to compliance by means of Self-governance. One way of implementing this approach is for industry to take a pro-active role by proposing modifications to the Codes to remove terms that may not be appropriate for Regulatory enforcement and to move them into subsidiary documents. These subsidiary documents may then be amenable to more robust compliance actions by means of Self-governance.

3.8. Some documents already have two parts (e.g. the BSC with the second tier being the Code Subsidiary Documents (CSDs)). This is also the model being developed for the Distribution Connection and Use of System Agreement (DCUSA).

3.9. The criteria through which the tier one / tier two delineation is set will also be important. Potential criteria for including terms in tier 1, could be:

- Likely to have a material/significant detrimental impact on competition or a class of company or the consumer,
- Related to the safety and security of the networks,
- Critical to the governance arrangements,
- One which the parties agree should be determined by Ofgem,
- One where we can envisage a situation where we would enforce the term, and
- Reflective of the core requirements of the licence.

3.10. The consideration of tier one and tier two of the documents could be led and resourced by the industry, with Ofgem having an observer role in the process. The development of the DCUSA, a new code governing the electricity distribution arrangements, has followed a two tier approach, and has been drafted by the future parties to it.

Option 5 Industry Self-governance of Codes

3.11. This option was first suggested in the context of the Supply Licence Review. Under this option, parties, via the Code Panels or some other mechanisms to be devised, would undertake enforcement action for any breaches of the Code, with no backstop by way of licence obligation. It should be noted that this approach has not found favour with stakeholders to date.

3.12. A prerequisite for implementing such an option along these lines would be the establishment of a suitably constituted body to administer the arrangements and to enforce sanctions. The decisions of the body applying the sanction would need to be accepted as final and binding perhaps through a specific commitment to this effect in the relevant Code or else would need an appropriate avenue of appeal against its decisions. The body applying the sanctions may also be subject to appeal or judicial review.

3.13. We would envisage that such a body would need the confidence of stakeholders in its ability to act independently. Stakeholders would also need to be confident that when carrying out any of its functions such a body would be transparent, proportionate and consistent. The OFT has published core criteria and guidance for their Consumer Codes Approval Scheme which may give some insights into appropriate governance³.

3.14. Before such an arrangement could be endorsed by Ofgem, we would have to be satisfied that the mechanisms for Self-governance of the Codes could deliver in all circumstances a better Regulatory environment from the point of view of the consumer and facilitating an effective market. Apart from the obvious need to meet the principles of better regulation, Ofgem would need to be assured that its withdrawal from enforcement in respect of Code breaches would be compensated by an effective and proven regime of incentive and sanction.

3.15. Whilst this option may not be achievable or desirable in the short term, it may be this option could be achieved over a longer timeframe, with the development of appropriate governance structures, possibly incrementally, for instance via Option 4.

Coterminous Modification Governance and Enforcement

3.16. As noted earlier in this document, although Ofgem has a remit for ensuring compliance with the Codes, we rarely undertake enforcement actions against companies. At present Ofgem often has an enforcement duty which extends far

³ OFT Consumer Codes Approval Scheme - Core Criteria and Guidance
<http://www.ofg.gov.uk/NR/rdonlyres/629F3587-953C-4609-AF90-51A144B859AE/0/oft390.pdf>

beyond its modification governance remit (for instance, Ofgem does not decide changes to the CSDs of the BSC and STC but it could, in theory enforce compliance).

3.17. One of the outcomes of providing a more extensive role for industry Self-governance will be greater clarity about which terms Ofgem and industry agree are sufficiently important that they should be capable of being enforced by the Regulator. A logical extension may be that terms which are sufficiently important for Ofgem to have an enforcement interest in, are also terms upon which Ofgem should make the final decision about changing. This suggests that the boundary between Ofgem's governance and enforcement roles could be coterminous.

3.18. If the boundary between enforcement and modification governance were not coterminous, two possibilities exist. The first of these is that Ofgem makes final decisions on changes to provisions which we do not consider are appropriate for Regulatory enforcement. The second is that we could have the capacity to enforce provisions which we may not have expressly approved (the current situation). During the ICCR we will invite industry to consider whether it would be appropriate for Ofgem to continue to hold an enforcement role over terms which can be varied by industry processes, and if so what appropriate mechanisms for achieving this might be.

4. Timing and Priority

Question 1: Do the resource implications of the options for reform set out above outweigh the benefits which the solution offers?

Question 2: Over what timescale would you expect the options to be delivered?

Question 3: Which of the Codes and agreements should the ICCR address, and in what order of priority?

Question 4: What resources is your business willing to commit to the development of the options and to reducing the Regulatory risk which may exist?

4.1. It is important to establish the extent of the Regulatory risk which industry faces. We invite parties to provide examples of the extent to which financially and otherwise, this issue impacts their business and to let us know the priority with which they consider the review should be undertaken. The different options described in the third section of this document are likely to have widely varying resource implications for both industry and Ofgem. Stakeholders, such as consumer organisations and service providers are also invited to consider the resource implications of the various options identified.

4.2. Before considering what changes might be made, it will be important to establish the criteria that need to be applied in determining whether a particular change should be implemented. The relevant criteria could be considered broadly as follows:

- Is there a deficiency in the existing regime that has a material impact on the interests of consumers and/or the effective operation of the market?
- Will the proposed change address those deficiencies? For example:
- Will it result in a reduced Regulatory burden for licensees?
- Will it result in increased Regulatory certainty?
- Will the proposed change achieve the objective(s) in a proportionate and targeted way?
- Are the costs and risks associated with making and implementing the change proportionate to the anticipated benefit?
- Will the proposed change have knock-on effects on other areas?

4.3. Attention needs to be paid to the mechanism through which any outcomes of the review may be implemented, in particular, via modifications to the Codes and licences. Indeed, a key consideration is the barriers that may exist to industry undertaking priority work on its own initiative including proposing changes to the Codes. The Review is likely to evaluate the difficulty and cost of implementing any reform, and whether this threatens its viability.

5. The Way Forward

Question 1: What resources is your business willing to commit to reducing the Regulatory risk which may exist?

Question 2: Are the steps outlined in this document to take this Review forward appropriate?

Approach

5.1. In these initial stages of the ICCR project we invite stakeholders to consider the questions raised in this document. Following the response to this document we intend to identify the most appropriate mechanism through which the objectives of the ICCR can be achieved.

5.2. During the consultation period we will host an ICCR seminar. The purpose of the seminar will be to give stakeholders the opportunity to comment on the objectives and principles of the ICCR, to discuss the options described in this document and understand how implementation of some of the options might impact their businesses.

5.3. Following the close of this consultation, a Steering Group may be convened, which would mainly consist of representatives of parties to the Codes, in order to facilitate discussion and the development of proposals. As the Review is developed Ofgem will issue consultation and conclusions papers and place these and other key documentation on the Ofgem website.

5.4. A detailed project plan will be developed including key milestones against which the project should be delivered. Ofgem will convene meetings to discuss the Review and issue further documentation as appropriate to ensure stakeholders remain involved in the project.

Deliverables

5.5. Expected deliverables are likely to include the:

- Establishment of a summer seminar to discuss the issues detailed in this paper,
- Establishment of an industry Steering Group to consider the matters within the scope of the ICCR,
- Delivery of a conclusions document setting out Ofgem's views on the issues considered during the ICCR and proposals on a way forward.

Appendices

Index

Appendix	Name of Appendix	Page Number
1	Codes and Agreements, their function and suitability for review	16
2	Consultation Response and Questions	21
3	The Authority's Powers and Duties	23
4	Glossary	25
5	Feedback Questionnaire	26

Appendix 1- Codes and Agreements, their function and suitability for review

UNC

1.1. Each Gas Transporter is required to enter into transportation arrangements in conformity with its Network Code; a document which it is obligated to produce under the terms of its Gas Transporters licence. The majority of the GB gas network was previously owned and operated by National Grid, with transportation arrangements being largely contained in a single Network Code. In 2005 National Grid sold four of its Distribution Network (DN) businesses. Whilst each of these new DN owners, along with National Grid, is still required to produce its own Network Code, in order to prevent inappropriate fragmentation the substantive provisions of these Codes are incorporated by reference to a common document, known as the Uniform Network Code (UNC).

1.2. Whilst shippers must sign the framework agreement which gives contractual effect to the Network Codes if they wish to ship gas across a given network, they are not obligated by licence to do so. It is a commercial requirement of participation in the market. However, Standard Condition 3 of the Gas Shippers licence provides that the shipper shall not knowingly or recklessly pursue any course of conduct which is likely to prejudice, amongst other things, the due functioning of arrangements provided for in the Network Code. In practice, enforcement of the Network Code is conducted by Parties themselves, with infringements often attracting contractual remedies, such as liabilities.

MRA

1.3. The MRA was introduced to provide a governance mechanism to manage the processes established between suppliers and distribution companies to enable suppliers to transfer customers. The other arrangements available at the time were not suited to dealing with the task of establishing coherent processes for all distribution networks in Great Britain. At the time, the balancing and settlement arrangements were different between England and Wales and Scotland. It was considered necessary to have uniform processes for managing customer transfers for all supply points, irrespective of location or market segment. The MRA created a baseline for the design of those processes and requires all distributors and suppliers to adhere to it.

1.4. The MRA was one of the first documents to contain standalone issues capable of being decided by the industry rather than by Ofgem. Given this existing split and the stability of the document over several years it may be that the MRA is one of the documents which is less suitable for review as part of the ICCR. Whilst that is the case it may be that improvements could be made.

BSC

1.5. The balancing arrangements in place in England and Wales prior to the existence of the BSC (known as 'the Pool') were perceived to have failed to react quickly enough to change, whilst concern existed over the effectiveness of the arrangements for bidding and price setting, as well as other market-related imperfections. The BSC was the primary document that brought in the New Electricity Trading Arrangements in 2001. These arrangements were extended to Scotland in 2005. The settlement aspect of the BSC relates to monitoring and metering the actual positions of generators and suppliers (and interconnectors) against their contracted positions and provides imbalance settlement between the parties when actual delivery or offtake does not match their expected positions. The energy balancing aspect allows parties to make submissions to National Grid to either buy or sell electricity into/out of the market at close to real time in order to keep the system from moving too far out of phase.

1.6. The BSC arrangements are broadly divided into two tiers. The BSC itself sets out the principles for what the balancing arrangements must deliver (the "what"), with its various working procedures (referred to as Code Subsidiary Documents, or CSDs) providing the mechanism(s) to deliver these principles (the "how"). The former may only be modified at the direction of Ofgem, whereas the latter may be modified by Panel Committees without reference to the Regulator. Both tiers fall under the enforcement role of Ofgem

1.7. It may be considered anomalous that Ofgem could take enforcement action against a signatory for failing to comply with provisions that may have been introduced or altered without reference to us, particularly if a case can be made that a signatory is in all other regards complying with the BSC. Assessing whether it is appropriate for us to have an enforcement remit that is wider than our change remit will form an important part of this review.

CUSC

1.8. The CUSC was introduced in June 2001 in order to replace the MCUSA, which had failed to enable the industry to bring about changes to the network access arrangements which were important if the potential benefits offered by the New Electricity Trading Arrangements were to be fully realised.

1.9. The document provides the legal framework which forms the basis of the contractual framework for connection to, and use of, National Grid's high voltage transmission system. Unlike the BSC, the CUSC is a one tier document which also includes a number of template bilateral agreements to be applied between parties as appropriate. The content of the CUSC may not be as amenable to a revised approach to enforcement as the BSC as the document is not currently separated into two sections. Additionally it may be the case that the content of the CUSC is less amenable to Self-governance due to its nature as a document which sets up a connection and charging regime between NG and its counterparties.

Grid Code

1.10. The Grid Code compliance obligation was introduced at the time of privatisation. There is now a single Grid Code which covers the technical aspects relating to the connection to and use of the GB Transmission System and specifies day-to-day procedures that govern the relationship between NGET and users of the GB Transmission System for both planning and operational purposes in both normal and emergency circumstances.

1.11. Given the Grid Code deals with issues which are important to security of supply, it is anticipated that it will be necessary for Ofgem to have an enforcement role. It may be that there are not entire parts of the Grid Code which are suitable for industry enforcement. It may be possible for the detailed procedures within the Grid Code to be split into two categories - one category containing the terms which set out what must be achieved, the other setting out in more detail how that obligation should be fulfilled. It may be that enforcement of the latter of these two categories could be appropriately dealt with through Self-governance.

1.12. Ofgem notes that the Grid Code was developed as a single document and such it may be a resource intensive exercise to separate it into two parts. Consideration should be given as to whether the perceived benefits justify the commitment of the resources required.

Distribution Code

1.13. The Distribution Code covers the technical aspects relating to the connection and use of the distribution licensee's distribution network. The Distribution Code specifies day-to-day procedures that govern the relationship between the distribution licensee and users of its distribution system for both planning and operational purposes in both normal and emergency circumstances. The Distribution Code is also designed to ensure that the distribution licensee can meet its Grid Code compliance obligations.

1.14. Given the Distribution Code deals with issues which are important to security of supply, it is anticipated that it will be necessary for Ofgem to have an enforcement role. It may be that there are not entire parts of the Distribution Code which are suitable for industry enforcement. We consider that it would be possible for the detailed procedures within the Distribution Code to be split into two categories - one category containing the terms which set out what must be achieved, the other setting out in more detail how that obligation should be fulfilled. It may be that enforcement of the latter of these two categories could be appropriately dealt with through Self-governance.

1.15. Ofgem notes that the Code was developed as a single document and such it may be a resource intensive exercise to separate it into two parts. Consideration should be given as to whether the perceived benefits justify the commitment of the resources required.

STC

1.16. Prior to April 2005 electricity was traded and transmitted in two distinct markets in Great Britain, one in Scotland and one in England and Wales. In order to facilitate the operation of single GB market for the trading and transmission of electricity, BETTA introduced NGET as the single System Operator for GB on 1 September 2004. NGET are now the only interface with Users for connection to and Use of transmission services in GB.

1.17. The STC was introduced as part of BETTA and defines the interaction between Transmission Licensees. The STC defines arrangements for: -

- Transmission Owners to make transmission services available to the GB system operator for its use so it can discharge its obligations under its Licence and the user facing Codes (CUSC, BSC, Grid Code etc),
- the GB System Operator to issue directions to Transmission Owners about the required configuration of the GB transmission system, and
- The planning of transmission outages and co-ordination of investment planning for the development of the GB transmission system (including new connections to the GB system).

1.18. The three transmission licensees each have an obligation to have in force and comply with the STC. The STC consist of two tiers - the Code itself and a number of STC Procedures (STCP). The STCPs are not normally subject to Regulatory oversight. As there is already a considerable level of Self-governance within the STC arrangements, the STC may not need to be reviewed in detail as part of the ICCR.

SPAA

1.19. The Supply Point Administration Agreement was created in order to provide governance around those supplier to supplier procedures which were not ordinarily covered by existing contracts or agreements, but which are nonetheless considered important to the effective and efficient transfer of consumers between suppliers. Current licence conditions are focused primarily upon domestic suppliers, though all Gas Transporters are also obligated by licence to accede to the SPAA and comply with some of its provisions. This is largely in recognition of the role GTs play in administering Supply Point information.

1.20. The SPAA is intended to be a largely Self-governing agreement, with relatively few of its provisions being mandated, instead carrying voluntary or elective status. Those provisions which are mandatory require the consent of the Authority before they can be added to, removed or amended. Failure to adhere to the mandatory provisions of the SPAA could ultimately attract licence enforcement. SPAA parties have also given consideration to the alternative sanctions, such as standards of service backed up by liabilities. However, to date none of these alternative sanctions has been introduced.

1.21. The scope of potential licence enforcement under the SPAA is strictly defined and the Code contains mechanisms which can facilitate the change in status of a given provision from non-enforceable to enforceable and vice versa. Whilst this is the case industry has found it appropriate to increase the sanction attached to a failure to comply with a number of provisions of the SPAA. As with the other Codes, it may be appropriate for the ICCR to review the mechanism through which Ofgem enforces the SPAA, but given the above it may be particularly appropriate to re-evaluate what provisions should be capable of being enforced by Ofgem.

Appendix 2 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. (In particular, we would like to hear from xxxx. If appropriate)

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by **1 September 2006** and should be sent to:

- David Edward
- Industry Codes and Licensing
- Ofgem, 9 Millbank, London, SW1P 3GE
- 020 7901 7435
- David.edward@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to identify the most appropriate mechanism through which the objectives of the ICCR can be achieved.

Any questions on this document should, in the first instance, be directed to:

- David Edward
- Industry Codes and Licensing
- Ofgem, 9 Millbank, London, SW1P 3GE
- 020 7901 7435
- David.edward@ofgem.gov.uk

CHAPTER: Two

Question 1: Are the objectives and the principles of this Review the right ones?

Question 2: The nature and extent of the Regulatory burden has not been clearly articulated by the industry. Given that Ofgem has undertaken very few enforcement actions for breach of Codes, are the risks posed not theoretical rather than practical?

Question 3: What is the nature and extent of the Regulatory risk faced by parties - What is the estimated cost to businesses?

CHAPTER: Three

Question 1: Which of the options set out below has the most merit?

Question 2: Should options 1 to 3 be considered and developed before options 4 and 5?

Question 3: To what extent is it possible and desirable for industry to make progress on Option 4 (and to some extent option 5) outside the framework of the ICCR?

Question 4: Do you have a view on whether Regulatory enforcement and Code modification decision making should be coterminous?

CHAPTER: Four

Question 1: Do the resource implications of the options for reform set out above outweigh the benefits which the solution offers?

Question 2: Over what timescale would you expect the options to be delivered?

Question 3: Which of the Codes and agreements should the ICCR address, and in what order of priority?

Question 4: What resources is your business willing to commit to the development of the options and to reducing the Regulatory risk which may exist?

CHAPTER: Five

Question 1: What resources is your business willing to commit to reducing the Regulatory risk which may exist?

Question 2: Are the steps outlined in this document to take this Review forward appropriate?

Appendix 3 – The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.⁴

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly⁵.

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them⁶; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁷

⁴ entitled "Gas Supply" and "Electricity Supply" respectively.

⁵ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

⁶ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

⁷ The Authority may have regard to other descriptions of consumers.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- Promote efficiency and economy on the part of those licensed⁸ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation⁹ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

⁸ or persons authorised by exemptions to carry on any activity.

⁹ Council Regulation (EC) 1/2003

Appendix 4 - Glossary

B

BSC

Balancing and Settlement Code

C

CUSC

Connection and Use of System Code

I

ICCR

Industry Codes Compliance Review

M

MRA

Master Registration Agreement

U

UNC

Unified Network Code

S

SPAA

Supply Point Administration Agreement

Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Do you have any comments about the overall process, which was adopted for this consultation?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- To what extent did the report's conclusions provide a balanced view?
- To what extent did the report make reasoned recommendations for improvement?
- Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk