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22nd January 2008

Dear Mark

Review of industry code governance

British Energy welcomes the opportunity to comment on the issues raised in your letter on the above dated 28 November 2007.

Headlines:

- **A review of elements of the code governance regime is timely;**
- **We do not believe fundamental reform would deliver a net cost-benefit;**
- **Concerns regarding insufficient modification assessment could be addressed at an early stage by more appropriate engagement by Ofgem at modification meetings;**
- **Review should consider whether the existing code governance regime should be supplemented to reflect the statutory objectives placed on GEMA when assessing code modifications;**
- **A stable regulatory environment in respect of transmission/distribution charging arrangements is important in order to create the right environment for long term investment. Continual review damages market confidence and does little to improve the perception of market/regulatory risk over the longer term;**

General Comments:

A review of elements of the code governance regime with a view to identifying whether any improvements can or should be made to the existing frameworks is timely. The codes that govern participation in the electricity and gas sectors were established at different times over the past 17 years from the Grid Code in 1991 to the Distribution Connection & Use of System Agreement in 2006. Furthermore, the statutory framework, through the Sustainable Energy Act 2003 and the Energy Act 2004, has also evolved since the implementation of the major industry codes. Consequently, it would appear timely to take stock and review whether the existing governance regime for each of the codes remains fit for purpose. However, it is possible that the statutory framework maybe further changed through the Energy Bill. Therefore, whilst it is timely to commence a review now consideration of

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possible future statutory changes that may impact on the code governance regime should also fall within the scope.

The core objective of an electricity and gas governance regime should be that it is consistent with the better regulation principles and should therefore be effective, targeted, consistent, proportionate and transparent. With this in mind, we support the broad objectives set out in your letter and agree that any changes proposed should be consistent with said objectives. On the whole, we consider the existing governance regime does satisfy these objectives to a large degree. However, some changes could be made to improve the regime in light of the changes highlighted above. We therefore support the review and believe there is case for the regime to evolve rather than for wholesale fundamental reform.

Is it time to look again at the effectiveness of code governance?

Yes. Overall the existing code governance regime, particularly in respect of the BSC and CUSC, has been inclusive, accessible and operated in an effective and efficient manner. Although recognising that improvements could be made in certain areas, we do not support the view that the existing governance is in some way an undue barrier to entry. However, it may be possible to implement some consistency across certain codes where there appears to be no just reason for different arrangements. For example, the rules on alternative modifications within the CUSC and BSC could be aligned.

It is clear that the code modification arrangements are open to interpretation. What falls within the scope of the relevant code objectives is one area and this is discussed further below. Another example where interpretation of the governance rules is unclear is the ability of GEMA to decide on a proposed modification to the BSC other than in accordance with the implementation date timetables set out in final modification reports. This latter issue is currently the subject of judicial review proceedings and is clear example of where regulatory uncertainty exists within the BSC code governance arrangements. It is clearly in the interests of all parties and Ofgem that there is a common understanding of the code modification rules and the possibility of issuing clear, simple and agreed explanatory notes should be considered.

Arguably it could be said that if a new industry governance regime was developed from scratch that was to be appropriate for the market today it would not replicate the existing governance model. However, any radical reform of the existing regime is likely to be extremely timely, costly and require a significant amount of industry resource. We do not consider there to be case for such fundamental reform and it is highly unlikely to satisfy any cost benefit test. It is right and timely to conduct a review and explore opportunities to improve the existing regime.

Critical analysis of modification proposals

We fully supported the introduction via the Energy Act 2004 of both the right of appeal and an obligation to have regard to best regulatory practice on the basis that these measures should lead to decisions taken by GEMA that are transparent, consistent and based on full and robust assessment. We note that Ofgem are expressing concern with the quality and depth of analysis provided to it through the code modification reports and whether this is hindering GEMA's ability to make decisions in line with best regulatory practice. On the whole we do not see this as a major problem and note that Ofgem has only identified a small number of code modifications where it has raised concerns. Consequently, any review should ascertain whether this is a widespread issue or one that is unique to certain modifications/codes. It is clearly possible for modification groups to undertake more analysis, testing, and evidence gathering, however, this is likely to require more resource and extend the assessment time required. Consequently, there is a balance to be met between 'gold plated' assessment procedures and the need for an efficient, economic and timely modification process.

We recognise that in the event that Ofgem receives a report with insufficient modification assessment it may impact its ability to make regulatory decisions that meet the best practice guidelines. However, given Ofgem may attend all modification meetings (e.g. Panels, modification groups, issue groups etc) it would appear that this perceived defect could be addressed at an early stage by more appropriate engagement by Ofgem at these meetings. This is similar to the situation where

commonly a Code Panel Member will attend, or in the case of the CUSC chair, a modification working group and amongst other roles will ensure that the workings of the group ultimately deliver a report that will allow the Panel to make a fully informed decision on the modification. We recognise that Ofgem cannot in anyway fetter its discretion by engaging in the modification process. However, requesting further analysis or clarification in order to allow it to meet its statutory obligations should not compromise its role as ultimate decision maker.

The relevance of code objectives – are they still fit for purpose?

It is essential that there is a common understanding of what falls within the scope of each of the code objectives. The current situation whereby GEMA assess code modifications against a wider set of objectives (e.g. sustainability, security of supply & social issues) compared to the code panels is potentially inefficient. Whilst we note that Ofgem has argued that the existing code objectives do allow for consideration of sustainability measures, the existence of a continual mismatch of modification assessment needs to be addressed in order to reduce any regulatory uncertainty. The review should consider whether the existing code objectives should be supplemented to reflect the statutory objectives placed on GEMA in assessing code modifications. Alternatively, the codes could be modified to facilitate Ofgem requesting particular analysis to be performed under a particular code assessment in line with its wider statutory duties. For example, analysis of the effect on emissions of a BSC modification would be work performed for Ofgem to assist in its wider objectives rather than a task which assists the Panel is assessing a modification against the BSC objectives which would remain primarily concerned with efficient system operation and promotion of competition. Furthermore, whilst we support the principle of consistency across codes it may not be appropriate to supplement the objectives of all codes due to the particular scope of the code in question e.g. the Grid Code.

Notwithstanding the above, it is timely to review whether the existing code objectives remain fit for purpose in light of experience. In particular whether justifiable code changes are being prevented by the specific code objectives. For example, we are aware that 'governance' type modifications are sometimes difficult to align with code objectives.

Charging Methodologies

We are yet to be convinced of the need to make substantial changes to the governance of the transmission and distribution charging methodologies. We note that Ofgem indicate that these methodologies can generate major impacts upon the decisions of market participants e.g. siting decisions for new plant. We support this view and this is one of the reasons why it is important that there is a stable regulatory environment in respect of transmission/distribution charging arrangements in order to create the right environment for long term investment. A continual review process is particularly damaging to market confidence and does little to improve the perception of market/regulatory risk over the longer term which ultimately is detrimental to the interests of consumers. We therefore do not support the option of moving the governance of these methodologies in to the codes. Furthermore, in the absence of any significant flaws in the existing charging framework we consider there to be a real need to draw a line under the current annual review process and introduce some stability and certainty into the transmission charging regime]. A possible solution could be to link the timing of charging reviews with that of transmission price control reviews.

Notwithstanding the above, allowing market participants the opportunity to propose modifications as and when charging reviews are commenced should be considered in order to make the process more inclusive and accessible.

Other issues

We consider the list of other issues set out in the paper are worthy of consideration with a view to exploring opportunities to improve the existing governance regime in line with the core and broad objectives. However, we do not consider that to resolve any of the issues would require fundamental governance regime change. In particular, we are not convinced of the need to move to more self-regulation within the codes which would require a timely and costly wholesale review.

As mentioned above, to draft a new fit for purpose code governance regime today from scratch is unlikely to replicate the existing model. However, the case for wholesale reform is unlikely to pass any appropriate cost benefit test. Therefore, significant change which can be relatively quick and simple to implement and which would clearly improve the industry code governance regime should be explored. For example, the possibility of merging the MRA into the BSC should be considered.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely



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