



Industry participants, consumer
representatives and other
interested parties

*Promoting choice and
value for all customers*

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Dear Colleague

Review of industry code governance

Many of the technical and commercial rules and obligations that govern participation in Great Britain's gas and electricity sector are set out in a series of multilateral codes¹.

Typically network operators are obliged under their licences to put these codes in place. Each code is designed to be capable of modification with the network operators, the signatories to the code and, in some cases, energywatch able to propose such modifications. The rules for how these proposals must be assessed vary from code to code, as does the extent to which changes are subject to self-determination by the industry or must be referred to Ofgem for decision.

Both individually and collectively the codes significantly impact on the shape and development of the gas and electricity sectors and, by extension, on our ability to deliver competitive markets that best protect the consumer interest.

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

It has been many years since some of the major codes such as the BSC and CUSC were introduced. Since then, other codes and agreements have been designated, we have seen significant structural change in the gas market through the Distribution Network sales programme, and, following calls for increased accountability in code decision making, there have been statutory changes to the regulatory framework within which the codes rest.

Some of the most significant statutory changes are contained in the Sustainable Energy Act 2003 and the Energy Act 2004. These include:

- The requirements on the Gas and Electricity Markets Authority (the Authority) to conduct Impact Assessments before reaching important decisions in defined circumstances;²

¹ On the electricity side of the market: the Balancing and Settlement Code (BSC); the Connection and Use of System Code (CUSC); the Grid Code; the Master Registration Agreement (MRA); the Distribution Code; the System Operator Transmission Owner Code (STC); and the Distribution Connection and Use of System Agreement (DCUSA). On the gas side: the Uniform Network Code (UNC) and short-form Network Codes; the Uniform Network Code for Independent Gas Transporters (IGT UNC); and the Supply Point Administration Agreement (SPAA).

² These requirements were introduced under section 6 of the Sustainable Energy Act : <http://www.opsi.gov.uk/ACTS/acts2003/20030030.htm>

- The introduction under the Energy Act of a right of appeal to the Competition Commission on eligible³ Authority code decisions; and
- The introduction under the Energy Act of better regulation duties on the Authority.

Both pieces of legislation underline the need for us to make our decisions based on credible evidence that has been appropriately tested and to ensure that our reasoning underlying these decisions is transparent and consistent. But whilst these obligations rest with the Authority, the nature of the code modifications process means that much of the day-to-day activity in evidence gathering and testing rests with industry and the code panels. The rules, behaviours, and resources applied to these activities can aid, or impede, our ability to reach an optimal decision on any given proposal.

Increasingly we have become concerned that there may be weaknesses in the way the codes are governed and that this may be preventing both industry and consumers from getting full value from these arrangements.

In addition to these factors, the entry into the market place of smaller players, such as distributed energy providers and micro-generation interests, has also led to concerns that the existing code arrangements are too complex and inaccessible. As such, we consider that it is timely to consider whether the code arrangements in their current form represent an undue barrier to entry to smaller players and whether there are changes that can be made to simplify these arrangements and reduce unnecessary regulatory burdens.

Critical analysis of modification proposals

Of major concern is the quality and depth of analysis provided to us in code modification reports and the extent to which arguments in support of code modifications (or for the retention of the status quo) are well substantiated.

Over recent months, Ofgem has raised a number of concerns regarding the quality of modification reports and the analysis undertaken on modification proposals both in the gas and electricity sectors⁴. In particular, we share the concerns of some market participants that modification reports and consultation documents often do not make sense on a standalone basis and lack an effective and critical assessment of modification proposals. In many cases both costs and benefits of proposals are not adequately assessed. Similarly, assessments of proposals against the objectives of the code in question are often limited and lacking in analysis that would enable us to conclude whether a change is merited.

Ofgem has also raised concerns over the past year regarding the effectiveness of existing workgroup processes and whether these workgroups are generating robust and critical analysis of modification proposals⁵. Further, if the conclusions of these groups, as set out in workgroup or modification reports, are opaque and/or misleading then those not present may effectively be disenfranchised from the process.

The need to ensure that the Authority's decisions are based on clear and transparent reasoning and robust analysis has been further emphasised by the recent decision of the Competition Commission on the appeal of the Authority's decisions on the gas offtake modification proposals. The Authority may only be able to meet the high standards required of it if the code modification reports themselves demonstrate well argued and effective analysis.

³ Decisions currently eligible are detailed here: http://www.opsi.gov.uk/si/si2005/uksi_20051646_en.pdf

⁴ Recent examples of this include UNC proposals 088 and 149/149a, and BSC proposal P213.

⁵ For example, concerns were raised by Ofgem at the August Balancing and Settlement Code Panel meeting that the workgroup process on modification proposal P212 meant that it was not being adequately assessed or developed.

Whilst the concerns we have outlined above do not necessarily relate to all modification reports that are submitted to the Authority, they nevertheless signal that there are deficiencies within the current arrangements. These deficiencies have the potential to generate risks and inefficiencies which may include (and may not be restricted to):

- the rejection of potentially positive changes to industry rules because they have not been justified;
- industry participants suffering from incorrect or incomplete understanding of the impacts of proposals on their organisations;
- necessitating unnecessary open letters or other forms of consultation to seek missing evidence, resulting in
 - resources to do this diverted away from other projects unnecessarily; and
 - avoidable differences in the evidence base that is available to us and to the industry and code Panels;
- unnecessary risk, to both consumers and industry, of sub-optimal decisions; and
- greater likelihood that subsequent modifications may be required to correct errors.

The costs of all these inefficiencies are borne directly by the industry, and indirectly by the consumer.

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

Each code has its own applicable objectives, against which the case for or against a proposal being made must be assessed. These objectives, which are largely based around the statutory duties of the network businesses, differ from code to code, but tend to share a common theme of relating to the promotion of competition, efficiency in network operation, and the development of co-ordinated and economic network infrastructure. Since the inception of the code objectives the wider statutory framework within which decisions on those codes must be made by the Authority has changed. As such, whilst the existing objectives have operated effectively over time, consideration may need to be given to whether the existing objectives should be supplemented in the light of the changing statutory framework.

For example, since October 2004 the Authority has been given duties relating to the achievement of sustainable development⁶. We have previously indicated that links between sustainability measures and existing code objectives can arguably be made. For example, in an open letter⁷ of 17 April 2007 to the CUSC Panel Chairman we highlighted that the costs of carbon emissions could arguably be factored into an assessment of efficient and economic network operation. We subsequently forwarded this letter onto the chairs of the Panels for the other industry codes. We will shortly be publishing further thoughts on how environmental issues can be considered within the existing objectives.

The consideration of environmental issues outlined above highlights the potential that differing participants may have differing perceptions on what is within the scope of the existing code objectives. If this is the case, there exists a risk that the code governance mechanisms may not provide for effective consultation or consideration of issues that are legitimately within their scope. This could result in the Authority being required to take decisions on modification proposals that have not been properly informed by industry and code panel consideration. We would therefore like to explore whether industry and other stakeholders consider that the scope and clarity of current code objectives is adequate.

Whilst this is potentially of most relevance to sustainability issues, there may be other areas in which there exists a risk of fragmented decision making processes – for example, on other issues such as impact on consumers, security of supply and better regulation.

⁶ Introduced by section 83 of the Energy Act 2004, which was brought into force by Statutory Instrument SI2004/2575: <http://www.opsi.gov.uk/si/si2004/20042575.htm>

⁷ Available here: <http://www.nationalgrid.com/NR/rdonlyres/2B5FDE28-2019-4B49-8488-6CB2F244363D/18170/OfgemResponsetoCUSCpanelFINAL.pdf>

It may therefore be appropriate for consideration to be given to whether additional objectives are needed to supplement the existing code objectives and whether the panel consultation and decision process should be adjusted to reflect the Authority's broader decision making framework.

Charging Methodologies

At present transmission and distribution charging methodologies that are used to derive network charges are governed wholly by gas and electricity network owners and operators under their licences. In preparing these methodologies network owners are required amongst other things to ensure that they are cost reflective (other than in cases of auctions) and secure effective competition.

These methodologies and the network charges can generate major impacts upon the decisions of market participants. In the short term, network charges can impact upon a market participants' willingness or ability to input or offtake gas or electricity. In the longer term, the methodologies can influence the siting decisions of electricity generation, gas production and industrial facilities. In addition, charging methodologies also have broader environmental and sustainability impacts, to the extent that they can influence the siting decisions of renewable generators.

At present however, market participants can only influence changes in these methodologies through consultation processes undertaken by the network owners. In particular, there is no ability for market participants to propose modifications to the charging methodologies themselves. This is a matter on which many industry participants have raised concerns, particularly those from the renewable generation sector. Another potential concern is that, in contrast to many of the industry codes that are in place, the governance of the charging methodologies is managed by the network operators themselves rather than through independent entities.

Given the broader impacts of charging methodologies on the market and on sustainability issues, there may be merit in giving consideration to changing the governance underlying these methodologies. This could be achieved by transferring the methodologies into the industry codes and ensuring that they are governed by independent code administrators.

Other issues

We have concentrated on a few of the key issues above, but these are not the only areas that may be worthy of review to determine whether the governance arrangements are working effectively. Further consideration of the following issues may also be merited:

- Issues relating to fragmented code administration and the multiplicity of code administrators, including
 - How this impacts on the assessment of cross-code issues
 - Whether this results in duplicated or conflicting governance in some areas
 - Efficiency incentives and cost controls on code administrators
 - Whether the proliferation of code administrators is desirable or should some of these functions be merged
 - Whether code administrators need to be independent of market participants;
- Whether there is scope for more self-regulation within the codes;
- Whether the structure of code Panels and other committees is appropriate;
- Whether there are deficiencies surrounding the provision and quality of legal text.

The review of governance will also need, through time, to take account of any developments in Europe, particularly the proposals for technical or industry codes which are part of the third legislative package. The Commission's proposals for a third legislative package envisage a number of codes on cross border issues which could impact on the current GB industry code arrangements.

Governance Review

In view of the issues and concerns outlined above, we intend to commence a project that reviews elements of the governance regime and identifies whether improvements can and should be made to the existing frameworks that apply in the gas and electricity sectors.

However, in order to fully determine the scope of the project and the issues that might be addressed, we consider that it is important to consult with and understand the views of industry participants on the effectiveness of the existing framework and whether there are particular deficiencies that need to be addressed. In defining the scope of the project it will also be important to understand the materiality of any deficiencies that are present. Once the scope of the project is defined we would then propose to consider options for change and the steps and processes by which change can be implemented where necessary.

We consider that there are a number core and broad objectives that need to be considered in defining the scope of the project and identifying potential changes. In particular, we consider a governance regime should:

- promote inclusive, accessible and effective consultation;
- be governed by rules and processes that are transparent and easily understood;
- be administered in an independent and objective fashion;
- provide rigorous and high quality analysis of the case for and against proposed changes;
- be cost effective;
- contain rules and processes that are sufficiently flexible to circumstances that they will always allow for efficient change management; and
- be delivered in a manner that results in a proportionate regulatory burden.

Way forward

We wish to see the industry codes develop in a way that will best protect the consumer interest and promote effective competition. We consider that a governance framework that facilitates robust regulatory decision making, and is in tune with the principles of better regulation, should help achieve this.

This letter has set out some areas of concern that we would like to further explore. It does not however, at this time, set out any specific proposals, remedies or alterations to the code governance regime. In the event that the governance review prompts the development of such proposals we will consult on them at the appropriate time. In the interim, we would welcome feedback on the broad issues that have been outlined in this letter and the nature of the issues that should fall within the scope of the governance review.

In order to allow us to take the views of interested parties into account in determining the scope of the review we would welcome written submissions. We request that any such responses are provided by 22 January 2008. We also intend to hold a Powering the Energy Debate event on this topic in the new year and we will confirm the date and agenda for this shortly. This seminar will be used to provoke debate and, as with the written submissions we receive, inform the scope of the governance review project. We would encourage industry participants to attend. In order to help us to plan this event we would welcome early expressions of interest in attendance to industrycodes@ofgem.gov.uk.

Yours sincerely



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