



ScottishPower

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25 January 2008

Dear Mark,

REVIEW OF INDUSTRY CODE GOVERNANCE

Thank you for the opportunity to comment on the issues highlighted in your open letter on the Review of Industry Code Governance. This initial response is submitted on behalf of the ScottishPower Group and ScottishPower Renewable Energy Ltd.

We believe that this review is timely and that improvements can be made to the current industry code governance framework that applies in the gas and electricity markets. We welcome future involvement in a project to review elements of the governance regime and identify where improvements can be made.

In our view, current code arrangements have become too complex and have not fully kept pace with changes in the wider energy landscape. The time is now right to consider what changes can be made to simplify these arrangements and ensure they enable the electricity and gas market in the UK to deliver its obligations whilst ensuring a level competitive playing field and security of supply.

On the question of simplification, it would be useful to look at merging some of the codes, which might also reduce the number of sensible reforms getting delayed or stuck as a result of cross-code issues. We would also suggest that:

- One of the most significant commercial issues faced by transmission users is the charging methodology. It is very important that transmission users have the right to propose changes in this area. Bringing transmission charging methodologies within the codes would also help where a code change had charging implications; both aspects could be considered together in a coherent manner.
- Further thought is needed as to whether there should be an analogous reform on the distribution side. On the one hand, principle suggests that distribution users should have similar rights as transmission connected ones; on the other, the wide range of charging methodologies that currently exists and the sheer number of parties who might propose modifications raise questions of practicability and cost-effectiveness.

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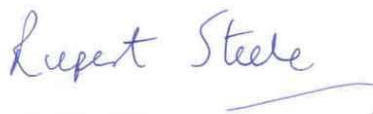
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- We strongly believe that, as a general principle, assurance of a level playing field is vital for an effective market and that the code objectives therefore must retain non-discrimination as a key principle. In general, the appropriate signals on carbon are provided through the ETS and it would be economically inefficient to use the codes to amplify them. The exception to this is renewable energy, where there are specific requirements at UK and EU level. It would make good sense for code objectives to include facilitating the development of renewable energy. It might also be helpful to mention security of supply.
- We believe that Ofgem should consider increasing the extent of self regulation, for example, by extending the current two tier approach, as currently used in the MRA and the BSC. Where decisions are of significant importance however, we believe Ofgem should continue to have the decisive role. It is important, however, that Ofgem exercises that role with care, especially in cases where a very clear industry panel verdict might be overturned, to avoid negative impacts on market confidence and investment in renewable and other generation. It might be useful to develop further guidelines to help with this.
- Finally, in relation to decisions on material modification proposals, we would encourage Ofgem to consider the merits of a simple mid-point review. This would enable Ofgem's high level input to be captured earlier in the process and would enable the group to align the analysis in the final report to Ofgem's requirements. We are keen to work with Ofgem to develop a more robust and efficient process in this area.

I attach a supplementary Annex which provides a more in-depth response on the matters noted above and which seeks to address the other key issues outlined in the open letter.

We are keen to discuss our response further with Ofgem, and I will be in touch separately about this. In the meantime, please do not hesitate to contact me if you have any questions or require any further information.

Yours sincerely,

A handwritten signature in blue ink that reads "Rupert Steele". The signature is written in a cursive style with a horizontal line underneath the name.

Rupert Steele
Director of Regulation

REVIEW OF INDUSTRY CODE GOVERNANCE

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

In assessing how the code governance arrangements have operated to date, it is important to recognise that electricity and gas markets have operated successfully over a period of significant change and extreme price volatility.

In our experience, the governance arrangements for the Balancing and Settlement Code (BSC), while cumbersome on some occasions, are those that have worked best and which may provide a useful indication for improvements to other codes.

The BSC was the primary document that brought in the New Electricity Trading Arrangements in 2001 with the aim of addressing the perceived failing of the Electricity Pool to react quickly enough to change. Since then the BSC Panel, supported by the company established to deliver the BSC, Elexon, has processed over 200 modifications of varying complexity, importance and urgency and has ensured that the process has been carried out in an unbiased and transparent manner. The BSC Panel uses modification groups, drawing from a list of industry experts, to assess and evaluate proposals where appropriate or may proceed directly to a report if the solution is felt to be sufficiently detailed and does not require further clarification.

The importance of the balancing and settlement arrangements covered by the BSC has ensured requisite participation of industry experts in the modification process. It is difficult to achieve this level of industry participation for other codes and is not appropriate for modifications with low impact on market participants. We believe there could be merit in extending the use of modifications groups comprised of industry experts to the other codes for modifications with a significant impact on market participants.

There is a perception that the code governance arrangements in their current form represent an undue barrier to entry for smaller players. We do not consider this to be the case as the code governance arrangements do not represent a barrier comparable to the necessary market entry, testing and accreditation arrangements for new entrants to the industry.

However, there are a number of areas where code governance issues do raise issues:

Code mergers and cross-code issues

The assessment of cross-code issues has always been a difficult area and will continue to be so where amendments to one code require other codes also to be amended. In our view it would be worthwhile investigating whether there is a case for merging the Connection and Use of System Code (CUSC) governance arrangements with the BSC arrangements. This would reduce the number of times sensible reforms become delayed or stuck as a result of cross-code issues. It would be important to ensure that a combined panel for these two codes would not be overloaded.

Similarly, we believe the industry would also benefit from a single UNC combining the current Gas UNC and Independent Gas Transporter's UNC. This would align gas with the current electricity model under the MRA. We also believe that the code governance arrangements for the UNC could be more transparent, particularly in the early stages of modification assessment, where a process similar to that adopted for the BSC would be beneficial.

Self regulation and Ofgem decisions

We believe that Ofgem should consider increasing the extent of self regulation and that there is therefore merit in re-examining for each of the major codes the appropriateness of a two tier approach, identifying areas where there will still be a need for Ofgem to retain a modification governance role and a role as enforcer of last resort with the remaining areas subject only to self governance. It could be appropriate as a safety net for modifications to these self governance areas to be appealed to Ofgem by any party that can show it is significantly impacted by the modification. The extent to which this two tier approach has been adopted to date varies significantly by code:

Balancing and Settlement Code

The BSC arrangements are divided into two tiers. The BSC itself sets out the principles for what the balancing arrangements must deliver, with its working procedures providing the mechanisms to deliver these principles set out in the associated Code Subsidiary Documents. The BSC may only be modified at the direction of Ofgem whereas the Code Subsidiary Documents may be modified by Panel Committees without reference to Ofgem.

Connection and Use of System Code (CUSC)

The CUSC is a single tier document with all amendments requiring Ofgem approval.

Uniform Network Code (UNC)

All amendments to the UNC require Ofgem approval.

Master Registration Agreement (MRA)

Certain provisions of the MRA require Ofgem approval for modification but it also contains standalone issues capable of being decided by the industry.

Distribution Connection and Use of System Agreement (DCUSA)

The DCUSA has a self governance model that in our view is operating effectively with issues split into Part 1 and Part 2 matters with Ofgem only required to determine implementation for Part 1 matters.

A consistent two tier approach implemented across these codes would significantly reduce Ofgem's modification workload while still ensuring a right of appeal to Ofgem for parties significantly impacted by code panel decisions.

Where modification proposal decisions are materially significant, we believe Ofgem should continue to have the decisive role. It is important, however, that Ofgem exercises that role with care, especially in cases where a very clear industry panel verdict might be overturned, to avoid negative impacts on market confidence and investment in renewable and other generation.

Although the introduction of appeal rights under the Energy Act 2004 has provided some recourse in the event of decisions by Ofgem which go against panel views, that process of decision; successful appeal and then new decision itself casts a shadow of uncertainty which would not be there if the original decision had followed the industry view.

While Ofgem will need to retain powers in this area, it is important to find a way whereby Ofgem can both avoid unnecessarily over-turning panel views, and provide confidence to the market that it will do so. The recent example of gas exit charging, where (following a successful appeal) it is still unclear what the way forward will be, suggests that a more measured approach would be better for all parties.

Further thought is needed on what the best way to create that confidence would be and whether it might be possible to lay down some sort of guidelines. Alternatively, it might be possible to reserve some classes of issue (such as renewables, climate change and energy security) to Ofgem and leave others with a greater degree of self governance - particularly when the panel has decided by a large majority that no change should be made.

Renewables Development

We would welcome improvements to current code governance arrangements as similar uncertainty is constraining renewable development.

An example of this is the recent rejection of an electricity transmission charging modification proposing a charge discount for generators opting for a single circuit connection, which would principally apply to small renewable generation. For this issue, there was considerable support from the industry for a discount based on the associated cost savings for generators who accepted a single circuit connection reflecting the risks associated with a less-firm and uncompensated connection.

However the system operator argued against its introduction on the basis of perverse incentive and Ofgem has agreed to a re-consultation. The earliest date now that any new mechanism can be introduced is April 2009 for a modification that was first proposed in 2006. Process amendments should be introduced to shorten timescales for such examples, which should only be re-opened in exceptional circumstances.

Supply Point Administration Agreement (SPAA)

The effectiveness of the SPAA has been impacted by the exclusion of industrial and commercial suppliers' requirement to accede to the agreement. We would support a review of the voting and funding arrangements to address concerns and to ensure that no one party or group of parties is commercially disadvantaged.

Critical analysis of modification proposals

Ofgem has raised concern on the quality and depth of analysis provided to it in code modification reports and the extent to which arguments in support of code modifications or for retention of the status quo can be substantiated. We agree that the Authority should expect to see code modification reports that demonstrate well argued and effective analysis. If this does not happen there is a risk that potentially

sub-optimal decisions are taken. However, it is important to recognise that analysis could still conclude that the effects of change are uncertain.

We think the main way to address this will be for Ofgem to give more assistance in terms of defining the kind of information and analysis it needs. In part, this could be a generic process. Ofgem could consult on and then issue guidance on the process for gathering evidence and for compiling code modification submissions, and it may then be appropriate to incorporate specific requirements within the change control processes.

However, we think that specific input may also help. We would encourage Ofgem to consider the merits of a simple mid-point review for the more material modifications, under which their senior staff engaged with the group to discuss progress so far. Although it should be for the group to prepare its own report, this would enable high level input to be captured earlier in the process. It would also enable the group to align the analysis in the final report to Ofgem's needs and to cover any specific points Ofgem had indicated as important.

We are keen to work with Ofgem to develop a more robust and efficient process in this area.

Analysis of modifications in gas

While the aim should be for a consistent level of analysis of modification processes across gas and electricity there will inevitably be differences as a result of the different historical development of the two markets and the need for half hourly balancing and settlement in electricity which is not a requirement for gas.

With the introduction of "User Pays" principles to finance future developments to gas industry systems, it is expected that more detailed analysis will be required prior to modifications being finalised and submitted to the Authority for determination. This analysis will not only determine the responsible parties required to finance the change but will provide a more detailed assessment of the benefits to be achieved.

Relevance of code objectives – are they still fit for purpose?

We agree that the existing code objectives have operated efficiently to date but in light of the changing statutory framework, consideration should be given to whether the existing objectives should be supplemented.

We strongly believe that as a general principle, assurance of a level playing field is vital for an effective market and that the codes therefore must retain non-discrimination as a key principle. In general, the appropriate signals on carbon are provided through the ETS and it would be economically inefficient to use the codes to amplify them. However, the exception to this is renewable energy, where there are specific requirements at UK and EU level. It would make good sense for code objectives to include facilitating the development of renewable energy. It might also be helpful to mention security of supply.

One difficulty with adding to code objectives is that this may dilute the transparency of modification decisions making it less clear as to how conflicting objectives have influenced the outcome, particularly those more difficult to quantify.

Although impact on consumers and better regulation are not explicitly included in current code objectives we think that such considerations are addressed in other ways. For example, network operators are required by their licences to meet pre-determined security standards. It seems to us that code modifications meeting existing criteria would be unlikely to have a significant adverse impact on consumers. The current framework requires the Authority to take into account its statutory duties, in particular its principle objective of protecting customers, in making a decision on a code modification. Better regulation can and should be addressed through such means as guidance to code review panels, rather than through adding further code objectives.

Charging methodologies

It is a major concern that market participants cannot propose changes to the charging methodologies which have major short term impacts on operational decisions and long term impacts on siting decisions for electricity generation, gas production and industrial facilities.

These considerations apply particularly to gas and electricity transmission, where in each case a single GB charging framework applies that delivers regional/zonal charges. It is here where there has been the biggest practical impact of changes to charging arrangements.

The charging methodology is one of the most significant commercial issues faced by transmission users. It is very important that transmission users have the right to propose changes in this area. Bringing transmission charging methodologies within the codes would also help where a code change had charging implications; both aspects could be considered together in a coherent manner.

However, further thought is needed as to whether there should be an analogous reform on the distribution side. On the one hand, principle suggests that distribution users should have similar rights as transmission connected ones; on the other, the wide range of charging methodologies that currently exists and the sheer number of parties who might propose modifications raise questions of practicability and cost-effectiveness.

Governance review

We broadly agree with the list of criteria that should be met by a governance regime. As set out above we believe the review should consider whether changes are needed “on-line” to codes and licences or “off-line” in the form of Ofgem guidance to promote the objectives concerned. Any proposals for change should be underpinned by a robust impact assessment.

We fully support the review and are keen to be involved in all stages of the process. It is important, however, to ensure that the current code governance arrangements, which are operating successfully, are not sterilised throughout the duration of the review and that beneficial modifications to the codes continue to be implemented.