Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Mark Feather
Director, Industry Codes and Licensing
Ofgem
9 Millbank
London
SW1P 3GE

Telephone: 01738 456400
Facsimile: 01738 456415
E:mail: Rob.McDonald@
scottish-southern.co.uk

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Your Reference:

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Dear Mark,

Review of Industry Code Governance

Thank you for the opportunity to comment on the review of industry Code governance. We welcome this review, though we do not share all of the concerns raised by Ofgem in the paper. We believe that the main focus of the review should be in two areas:

1. Bringing the charging methodologies under the governance of the appropriate Codes; and

2. Moving towards a position where Ofgem are not involved in the direct regulation of industry Codes.

1. Charging Methodologies

We believe there is a clear case for moving the charging methodologies to within the scope of the appropriate Codes. As noted by Ofgem, these methodologies can and do have a significant impact on market participants, indeed greater than other risks arising out of the Codes. The charging arrangements in both electricity and gas transmission impose costs of some £1.7bn on the market and can vary significantly year-on-year. For example, we have also seen year-on-year increases in charges of over 130% at certain sites. There is also growing evidence that the transmission charging methodology is not cost reflective and is acting against the efficient deployment of new and renewable generation. Despite these concerns, there is no direct involvement by market participants in putting forward change proposals to the methodologies.

In addition, the separate governance of the charging methodologies can cause inefficiencies in:

i) the assessment of modifications to the Codes, e.g. amendments to the Connection and Use of System Code (CUSC) cannot be readily assessed as there can be a knock-on impact on Charging e.g. this has been seen in CUSC Amendment Proposal (CAP) 143, Interim TEC; and

ii) the management of a change in the charging methodology, e.g. a change in the gas charging methodology can result in a raft of consultations and changes to the Uniform Network Code (UNC) to put in place the methodology.

Bringing the methodology under the Code would increase efficiency and minimise this duplication of effort. This amalgamation should not be too problematic. As is noted in Ofgem's current consultation on Revised Guidance on Impact Assessments (IAs), the treatment of changes to the Codes and Charging are very similar (to the extent that they are considered together in the IA consultation). Bringing the methodologies under the Codes should also result in greater transparency of the charging models, which can only be of benefit to the market.

In taking these proposals forward, the focus should be on Transmission methodologies in gas and electricity, given their GB application, the scale of costs and the potential to create significant windfall gains and losses. This however would not preclude Distribution charging being placed within a similar governance arrangement in the longer term.

2. Withdrawal of Ofgem from Industry Governance

We believe Ofgem's continuing oversight and micro-regulation of each of the industry Codes is no longer appropriate in the competitive market. Given the establishment of competition to date in both the wholesale and retail markets, we do not believe that it is necessary or appropriate for Ofgem to be involved in the minutia of Code changes. For example, under the BSC, <u>all</u> Code modifications go to Ofgem for approval/rejection. Since the start of the BSC, this means that 194 modifications have gone to Ofgem for a decision, which includes nine modifications that were simply "housekeeping" modifications. The medium term aim of this review should therefore be the development of a detailed plan of withdrawal of Ofgem from the direct regulation of the industry Codes.

In the shorter term, we believe that in the majority of Codes, the modification processes could be changed along similar principles to that used in the Distribution Code Use of System Agreement (DCUSA). The DCUSA is based around a two "Part" process where modifications are streamed into Part 1 and Part 2 Matters dependent on their importance and which sections of the Code they impact on. We believe that this could be extended to three "Parts" to allow more modifications to be decided without the need for Ofgem's automatic involvement. The adoption of a three-part process similar to that of the DCUSA would be a first step towards Ofgem's withdrawal from regulation of the Codes.

We have provided an example of how a potential amended modification process might work in the Appendix to this response.

Our comments on the other aspects of the review are given under the headings used in Ofgem's letter.

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

There have been significant changes since the Codes were first introduced, most notably the changes stemming from the Energy Act 2004 and the Sustainable Energy Act 2003. These Acts have emphasised the need for Ofgem's decisions to be based on robust and credible evidence. Ofgem are concerned that whilst the final decision on Code modifications invariably rests with them, under the present arrangements the production of evidence generally rests with the industry processes and in some cases has been considered lacking (by Ofgem). We have not had any issues with the evidential gathering arrangements nor indeed do we view the present arrangements as a barrier to new entry, though further streamlining of the modification processes as indicated above, can only simplify these processes and thereby assist new entrants. However, as noted above, we agree that a review of Code governance is overdue.

Critical analysis of modification proposals

We do not share Ofgem's concerns with the quality and depth of analysis provided as part of the modification processes, albeit we are not the main users of this work. We believe that the use of peer review of evidence (through work groups and industry consultation) and indeed the production of independent evidence provided by participants is perhaps underestimated in confirming the robustness of evidence. At the same time, Ofgem have close, day to day, involvement at the work groups and can provide guidance on any particular evidential needs of Ofgem.

To the extent that there have been issues with the administration and quality of reports, in our view these have been more evident where the secretariat function is not at arm's length from the Licensee, e.g. we have seen last minute changes to reports under the CUSC.

If efficiency and cost improvements are to be had from the administration of the modification processes, we believe that these could be realised from three initiatives:

i) the application of some form of incentive/penalty mechanism on the Code administrators, judged by independent review;
ii) the potential amalgamation of the administration functions across the Codes; and
iii) the imposition of a charge on the participant raising a modification.

Ultimately, Ofgem are required to produce an Impact Assessment (IA) for "important" modifications, and to that extent, conduct their own analysis. We would welcome greater depth and transparency of Ofgem's analysis, which should improve the efficiency of the process and minimise the number of appeals. In addition, we welcome Ofgem's current consultation on Revised Guidance on Impact Assessments, and will respond in due course.

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

The Authority has always had a wider remit in its consideration of Code modifications than those that apply to the Panels. This mismatch has increased with the widening of the Authority's duties to include secondary duties under the Acts.

Ofgem helpfully provided guidance in April 2007 on the treatment of carbon costs in the efficient and economic operation of the network. The provision of similar guidance to the Panels for other wider objectives could be beneficial.

The provision of e.g. wider Terms of Reference for the Panel to open up the scope of the Panel's decision making could allow the Panel to more appropriately assess modifications in line with Ofgem's wider duties, without having to change the Code objectives or the Licences of the network businesses. However, this could also raise issues of vires and ultimately place doubt on how legally robust a Panel decision might be in these circumstances. In addition, consideration would need to be given to the Licensee's position if the Panel could make recommendations that conflicted with the Licensee's narrower licence obligations.

Whilst in principle we recognise that benefits would accrue from alignment of the Panel's decision parameters with Ofgem's wider duties, it is likely to prove difficult for the Panel to reflect the same hierarchy on Primary and Secondary duties as Ofgem. In addition, any informal mechanism, such as providing wider Terms of Reference to the Panel would need to be legally robust to challenge further down the modification process. Finally we are not aware of many modifications where the potential mismatch in the Panel and Ofgem duties has, in practice, caused a problem. For these reasons we do not see a strong case or a pragmatic method for changing the Panel's objectives.

Other Issues

Cross-Code issues

The main cross-Code issue has been highlighted above, that is, that Charging methodologies lie outside the Codes resulting in inefficiencies and duplication of effort. However, other than this, in general, we do not believe that cross-Code issues require urgent attention.

Supply Point Administration Agreement (SPAA)

We strongly supported Ofgem's proposal to introduce a SPAA in gas on the grounds that it would offer an equivalent to the Master Registration Agreement (MRA) in electricity. The SPAA however has been implemented with a major shortcoming in that it is voluntary for I&C-only suppliers. It has therefore not resulted in the transfer of retail-related sections of the Network Code into the SPAA. As a result, it has failed to deliver its objectives. Consistent with Ofgem's remit of delivering better regulation, we believe that it is now time to address this shortcoming by reintegrating the SPAA back into the UNC and abolishing the SPAA. The review of Code governance should in itself improve the governance of the UNC to a point where a separate retail governance is unnecessary.

Ofgem's direction of modifications

We have seen instances in the past where Ofgem have used the Licence modification process to impose changes to the Codes, e.g. most recently, the imposition of Transfer and Trade obligations in gas. We do not believe that this is an appropriate use of Ofgem's powers and certainly does not fit with Ofgem's withdrawal from

involvement in the Codes. We would therefore urge Ofgem to refrain from adopting this approach going forward.

Scope of documents to be included in the review
We would be strongly opposed to industry documents such as the SO-TO Code (STC), the GB SQSS and Engineering Recommendation P2/6 (ER P2/6) being brought within the scope of the review. These are technical documents that should not form part of the general review of multi-participant Codes. In addition, whilst it may be appropriate in the longer term to subsume the Independent Gas Transporter (IGT) Codes into the UNC, we do not believe that it would currently be a positive cost benefit, nor that it is an imperative at this stage of the review.

We hope that you find our comments helpful.

Yours sincerely

Rob McDonald
Director of Regulation

Appendix – Amended Code Modification Process

Proposed changes to industry Codes are varied in their characteristics, and a single process for dealing with them is not efficient. A flexible approach is required, at the same time preserving the robustness of process but also not standing in the way of innovation. This classification below is intended to be generic and should be applicable across the majority of codes. It reflects the classifications used in the DCUSA.

- When a change is submitted to an industry Code, an initial assessment (to include a short industry consultation) will be made by the industry Code administrator and Panel to determine the class of the change. This will determine the route it will take to decision, and then appeal. This initial assessment to classify the change will be capable of veto by Ofgem (i.e. Ofgem do not have to approve the classification, but would retain the right to object if it strongly disagrees).

- There are three types of change:-

    - Class A - those which are operational in nature, and which ought to be determinable by the parties themselves. This would include housekeeping modifications, changes to data flows, process changes etc.

    - Class B - those which have a trading/commercial impact on parties, including a re-distribution of moneys, or a party specific liability.

    - Class C - those which involve changes to the principles of operation of the market, or the governance of the code.

    The two "Part" process of the DCUSA (i.e. modifications are streamed into Part 1 and Part 2 Matters) would be extended to accommodate these three types of modifications. The adoption of a three-part process similar to that of the DCUSA would be a first step towards Ofgem's withdrawal from regulation of the Codes.

- Processes

    - Class A
        - Ofgem receive copies of change process documentation including any working groups, and may attend meetings if they wish.
        - Industry Code governance (not the Panel) determines whether the change should be made.

        Notes
        - Ofgem can declare decision void if it can show that the outcome is no longer a Class A change.
        - A party may appeal the outcome to Ofgem on the basis of process, undue prejudice or Ofgem's decision to declare void.

    - Class B
        - Ofgem attend working groups, and receive all change process documentation.
        - Industry Code Panel determines whether the change should be made.

Notes

- Ofgem can declare decision void if it can show that the outcome is no longer a Class B change.
- A party may appeal the outcome to Ofgem on the basis of process, undue prejudice or Ofgem's decision to declare void.
- Appeal to the Competition Commission remains.

- Class C
  - Ofgem attend working groups, and receive all change process documentation.
  - Industry Code Panel make a recommendation on the change to Ofgem.
  - Ofgem would determine whether the change should be made.
  - Appeal to the Competition Commission remains.