

Review of industry code governance – scope of the review

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Overview:

This document follows on from our November 2007 consultation and sets out the Authority's conclusions on the scope of the industry codes governance review. Whilst the codes have served industry and consumers well in delivering incremental reform, the regulatory and market landscape are going through significant change at present, particularly with an increased emphasis on carbon reduction and renewables. In this context, it is important to consider whether the codes and charging methodology governance arrangements remain fit for purpose.

Ofgem is concerned that the codes arrangements are unable to deliver key strategic reforms and have not evolved sufficiently to take into account smaller supplier and renewables interests. We propose a programme of consultation on measures to address these shortcomings and improve the codes' ability to manage the major challenges facing the gas and electricity industry. The programme will also consider measures to reduce complexity and improve code administration, as well as self governance measures that seek to reduce Ofgem's role in areas of low customer impact.

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In November 2007 we published an open letter signalling our intention to conduct a review of the various industry code and charging methodology governance procedures. We considered that such a review was timely given the changes that have occurred to the Authority's statutory duties and functions since many of the codes were established. There have also been significant changes in the market including increased participation from smaller players such as renewables interests.

The review raises concerns as to whether the existing industry codes arrangements are capable of delivering major pro-competitive reforms in key policy and strategic areas. Evidence suggests that the codes governance arrangements are not effective at delivering coordinated and timely reform in key areas and that this has detrimental impacts on new entrants, smaller players and renewables interests.

The review questions whether the codes arrangements have become too complex or fragmented and whether changes can be made to simplify the arrangements or reduce unnecessary burdens, particularly for new entrants and smaller participants. A key area of concern identified by the review relates to the role of code administrators and the quality of code modification assessments delivered to the Authority.

The review also asks whether there are better regulation benefits in Ofgem stepping back from direct involvement in less material modification proposals and allowing code parties to govern the arrangements themselves.

Our November 2007 open letter also identified a number of other issues with the current governance framework including, amongst other things, whether the code objectives should reflect the Authority's statutory duties, such as those relating to sustainable development and the environment, and whether market participants should be able to propose modifications to network charging methodologies.

- Open letter announcing review of industry code governance - 284/07, November 2007:
www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/Open%20letter%20announcing%20governance%20review.pdf
- Corporate Strategy and Plan 2008-2013 - 34/08:
www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/CORPORATE%20STRATEGY%20AND%20PLAN%2028%20MARCH%202008.pdf
- Electricity Distribution Licence Review: Conclusions and Statutory Consultation - 50/08, April 2008:
www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/Sof%20C%20Project%203608.pdf

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Summary

This document sets out the Gas and Electricity Market Authority's (the Authority) conclusions on the scope of the industry codes governance review which was consulted upon in November 2007. Each of the industry codes have now been in operation for a number of years and the review comes at a time when there have been and, continue to be, significant changes occurring to the regulatory and market landscape since many of the industry codes were created.

The Authority's role in relation to code modifications has changed with the introduction of statutory duties governing matters such as sustainability, the environment and better regulation, as well as the introduction of appeals of code decisions to the Competition Commission.

The market landscape is also changing. The entry of smaller suppliers, as well as renewable and distributed generation has led to concerns that the code arrangements are too complex, fragmented and an undue barrier to entry. These concerns, which are reflected in responses to our November consultation, have manifested themselves across a number of areas, including the drafting of code modification reports which are often opaque in nature. Each of these issues is also of concern to the Authority, particularly in the context of the Energy Supply Markets Probe which is considering barriers to entry in the electricity and gas sectors.

In addition, whilst the codes arrangements have worked well to deliver incremental reform across a wide range of areas, we are concerned that the arrangements are hindering progress on key and strategic reform initiatives. Two examples of this are electricity transmission access reform and electricity cash-out reform. These initiatives could provide important pro-competitive benefits to customers in terms of facilitating new entry and reducing barriers to participation in the market for smaller players, including renewables interests.

The Authority is concerned that the problems experienced on electricity transmission access and electricity cash-out reform reflect underlying issues with the code governance processes which cause delays in the progress of major reforms. These problems have also been identified in the critique prepared by the Brattle Group and Simmons and Simmons on the codes governance arrangements (commissioned by Ofgem) which has been published today. In the case of major reforms delays can be caused by multiple and piecemeal proposals being raised on key issues, cross code/licence issues as well as divergences in views as a result of the commercial interests of different players.

In view of these concerns, the Authority has decided to initiate a major programme of work on the codes and charging methodology governance arrangements to ensure that they remain fit for purpose and preserve competition in a changing market landscape. In setting out the scope of the review and the work-programme, it is important to note that the Authority is seeking to build on the existing codes arrangements rather than fundamentally changing the codes themselves. Indeed, at this time, the Authority does not intend to explore fundamental changes such as code mergers or mergers of code administrators. The Authority has identified 6 key

work-strands to be taken forward by Ofgem through a **comprehensive consultation process**:

Delivery of major policy reform and self governance. Ofgem will consult with industry participants on a framework under which Ofgem would manage major policy changes by initiating and leading high level policy reviews, where the conclusions of the review would be legally binding, for example, upon relevant code panels/industry participants to implement through modification proposals. In parallel we will also consult on proposals to enable Ofgem to step out of the codes decision making process on proposals that have low customer impacts. We consider that this work-strand could bring potential benefits to smaller players and new entrants in progressing pro-competitive reforms which would ultimately benefit customers. In addition, it could potentially provide better regulation benefits by introducing industry self governance over certain modifications.

Any proposals governing the delivery of major policy reforms and self governance would be consulted on as a **package**.

Role of code administrators. Ofgem will consult on a range of options intended to improve the quality of analysis undertaken by code panels and administrators on code modifications. This has the potential to increase transparency with benefits to new entrants and smaller players. In addition, we will consult on measures to improve the efficiency and accountability of code administrators.

Initiatives to support smaller players. We also intend to explore, as part of our work on the role of code administrators, whether there are requirements we can place on code panels and administrators to consider the needs of smaller suppliers and generators.

Addressing complexity and fragmentation. Ofgem intends to convene a working group of code administrators to explore simplification and convergence of code modification processes and encourage best practice. Reduced complexity should benefit all parties and assist new entrants in participating in code processes and influencing policy outcomes where at present there are barriers to doing so.

Charging methodologies. The charging methodologies developed by the networks have impacts upon both the operational and siting decisions of market players. Similarly the methodologies have significant distributional effects and impacts on carbon costs. Ofgem will consult on a range of options that could make the charging methodology change process more accessible to market participants.

Code objectives. Ofgem will consult on amending the industry's decision criteria on code modifications to take into account environmental impacts, building on Ofgem's guidance on the treatment of carbon costs under the existing code objectives.

Progress on each of these work-strands will require significant consultation with industry participants and other interested parties. This will require assessment of the options against the criteria set out in our November 2007 letter. Given the number of work-strands and the nature of the issues we expect this work programme to progress over at least the next 12 month period. An indicative timetable governing the different work-strands is set out in Appendix 2.

1. Introduction

Background to the review

Consultation on the scope of the review

1.1. On 28 November 2007 we initiated a review of the industry codes governance arrangements ('the governance review') and consulted upon a number of issues and areas of concern which we considered would be worthy of consideration as part of the review.

1.2. In our November 2007 open letter we outlined that it has been many years since some of the major industry codes were introduced, and that there had been recent significant changes in the market and regulatory landscape.

1.3. In terms of the statutory framework there have been important changes including:

- Changes to the Gas and Electricity Market Authority's (the Authority) statutory duties, including, for example, duties relating to sustainability and the environment and the introduction of a better regulation duties
- The introduction of rights of appeal to the Competition Commission on eligible Authority code decisions
- The requirements on the Authority to undertake Impact Assessments before reaching important decisions in defined circumstances.

1.4. Our November open letter also noted the changing nature of the market place and the entry of smaller players such as renewable and distributed generation providers.

1.5. Our November open letter noted that there are concerns that the existing code arrangements are too complex and inaccessible, particularly for the smaller new entrants in the market. More generally it stated that Ofgem was 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 the code arrangements.

1.6. In the light of this, the open letter indicated that it was timely to consider whether the codes arrangements 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.

1.7. The open letter set out a number of key areas and concerns that could be explored as part of a broad industry codes governance review. These areas included:

- The quality of analysis undertaken on modification proposals;
- Whether the code objectives should be aligned with the Authority's statutory duties;
- The governance of the network charging methodologies and whether industry participants, other than network owners, should be able to propose changes to these;
- Code fragmentation, multiplicity of code administrators and complexity;
- The scope of self governance or self regulation within the codes; and
- Efficiency incentives and cost controls on code administrators.

1.8. Copies of the responses to Ofgem's consultation have been published on Ofgem's website at www.ofgem.gov.uk.¹ High level summaries of the views of respondents on the issues outlined in our November 2007 open letter are set out in Chapter 2. A list of the non-confidential responses can be found in Appendix 1.

1.9. In addition to our November 2007 open letter consultation we also held a Powering the Energy Debate (PED) event in February 2008 where we received presentations from a number of speakers from different sectors within the industry outlining their perspectives on the governance arrangements².

1.10. We have also commissioned an independent critique on the codes governance arrangements. This was undertaken by the Brattle Group (Brattle) and the law firm Simmons and Simmons. A copy of this critique has been published today and can be found on Ofgem's website. The critique is referred to in this document as the Brattle/Simmons and Simmons report.³

Codes governance and key policy reforms

1.11. We are also concerned that the codes arrangements have hindered progress on key reform initiatives many of which could provide important pro-competitive and customer benefits which would facilitate new entry and reduce barriers to participation in the market for smaller players, including renewables interests. These processes have also become increasingly dominated by larger incumbent energy companies who have the resources and capability to deal with the complexity of the governance arrangements, and in turn, the ability to influence policy outcomes, relative to new entrants and smaller companies who find it difficult to engage because of the complexities and resource commitments involved. We set out below our concerns regarding the progress of two key reform initiatives that have significant impacts on competition.

¹ Copies of the responses to the consultation can be found on Ofgem's website at <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=3&refer=Licensing/IndCodes/CGR>

² Slides from the PED event are available at: <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>

³ <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>

Electricity cash-out reform

1.12. In the case of electricity cash-out we have previously expressed our concerns that the industry codes governance arrangements have failed to address serious defects in the existing cash out rules that impact disproportionately on renewable generators, small generators and suppliers. In the case of one modification proposal (P212) we have expressed our concern that the modification proposal was not fully developed by the governance processes despite having merits. In addition, there has been an absence of coordination in the development of the cash-out review proposals, which has resulted in different proposals being raised over an extended time period, despite Ofgem's concerns on cash out being well known to industry participants for some time. We are concerned that the lack of coordination in the development of proposals for reform of the electricity cash out arrangements is having direct impacts on new entrants and smaller suppliers with consequential negative impacts on competition and customers.

Electricity transmission access reform

1.13. Similarly, in the case of electricity transmission access we have been disappointed by the progress of reform to the access arrangements, despite the sustained presence of significant constraints on the electricity transmission system and a queue of parties seeking access, as well as significant funding for investment through the Transmission Price Control Review. The absence of any reform in this area has had particular negative impacts upon smaller renewable players. Over the past year a number of proposals have been submitted to the Authority for decision seeking to improve different aspects of the access arrangements. In one case, Ofgem received 32 alternative proposals to consider following a significant period of development and consultation. It is only recently that a coordinated process has been developed with a range of modification proposals being raised exploring the merits of different access models. There remains a significant risk in this context that legislation may be required to address the concerns and any such action taken by the government would reflect a failure in the codes governance arrangements.

Purpose of document

1.14. This document sets out the Authority's decision on the scope of the review and the work-strands that Ofgem will be taking forward over the coming months in order to progress the review.

1.15. The scope of the review and the work-strands set out in this document were agreed by the Authority at its June 2008 meeting.

1.16. The Authority's decision on the scope of the review has been informed by the responses to the November open letter consultation, and the views expressed at the Ofgem PED event held in February. The decision has also been informed by the Brattle/ Simmons and Simmons report.

1.17. In setting out the scope of the review, Ofgem would like to thank those industry participants who have taken the time to contribute to the debate on its scope, through the submission of written responses to Ofgem, and by providing information and responses to the Brattle questionnaire. Ofgem would also like to thank those industry participants who presented at and contributed to the February 2008 PED event.

2. Authority's conclusions on scope of review

Chapter Summary

This chapter sets out the Authority's conclusions on the scope of the review taking into account the views of respondents and the recommendations set out in the Brattle/Simmons and Simmons report⁴.

Major policy reform and self-governance

2.1. In our November 2007 letter, respondents were asked for views on whether the codes arrangements were working effectively, including whether the fragmented nature of the arrangements impacts on the assessment of cross code issues and also whether there is more scope for self regulation. We also raised concerns that the code arrangements in their current form may raise an undue barrier to entry to smaller players and that the arrangements are complex and inaccessible.

2.2. Since issuing our November 2007 letter we have raised concerns that the industry codes governance arrangements are failing to deliver changes in key policy areas.

Respondents' views

2.3. Several participants have raised concerns that the codes arrangements do not effectively address cross code issues and that measures need to be established to address this. Related to this, some respondents agreed that the code arrangements do not effectively address strategic issues.

2.4. Several respondents also expressed the need for greater self governance with not all decisions being made by Ofgem. Some suggested that greater self governance should be combined with rights of appeal to Ofgem. Some respondents however considered that more self regulation would be contrary to the objective of an inclusive and accessible governance regime, with a risk that smaller parties are disenfranchised.

Brattle views

2.5. Brattle concludes that the inability of the code governance arrangements to progress and assess fundamental changes is a fundamental flaw in the codes arrangements. Brattle considers that whilst the arrangements are designed to process incremental change, they are not well suited to managing changes in areas with significant public policy implications or where multiple simultaneous rule

⁴ The Brattle/Simmons and Simmons report indicates that the views expressed in the report are the responsibility of Brattle (with Simmons and Simmons having provided legal input). As such, all references to the report in this chapter are to Brattle's views.

changes are required across multiple sets of rules. Brattle also comments that there is a significant level of redundancy in having both the panels and Ofgem carry out an assessment of a proposal. Brattle therefore proposes a two tier framework for the management of codes decisions. For issues which raise high level public policy matters, Ofgem could lead an issues review, the conclusions of which could be legally binding with a requirement on industry to implement the proposals. For less material issues the assessment process would be managed by industry through self governance with decisions being made by industry without Ofgem being involved as a decision maker.

The Authority's Conclusions

2.6. A major deficiency identified by Ofgem and also Brattle is the inability of the codes arrangements to progress major reforms in key policy areas. The resultant delays are often caused by:

- multiple proposals being raised on key policy issues;
- piecemeal development of proposals, with proposals often being raised on similar issues several months apart;
- cross-code and code/licence/charging methodology coordination issues; and
- divergences in the commercial interests of different players, some of whom may be opposed to reform.

2.7. The Authority considers these processes create inefficiencies and can also have negative impacts on competition, new entrants and customers to the extent that pro-competitive reforms are not progressed.

2.8. Some examples of these deficiencies are set out in Chapter 1 and include electricity transmission access reform and electricity cash-out reform. However, it is also important to note that these difficulties are not confined to the electricity sector. Whilst many of the problems are currently being experienced in the electricity sector, this does not preclude problems arising under the gas sector with the progress of key policy reforms. Indeed, difficulties in coordinating cross code and licence changes have been present in the gas sector. The need to coordinate code and licence changes has often arisen in the gas sector where changes to key policy areas, such as the gas entry capacity regime, have in some instances led to difficulties on timing and implementation.

2.9. The Authority is also concerned that the codes arrangements are so complex that new entrants and smaller players find it difficult to engage in these processes and influence change, including major pro-competitive change. As a result of this, codes discussions can become dominated by the larger incumbent energy companies

who have the resources and a better ability to influence outcomes relative to the smaller participants.⁵

2.10. The Authority also agrees with Brattle and respondents that it is involved in assessing many code modifications that have little material customer impact. This also leads to inefficiencies and duplication of work by both the industry and Ofgem in assessing proposals.

2.11. We will therefore consult with industry participants on establishing a framework to address the concerns outlined above regarding the progress of major policy reforms and the inability of smaller parties and new entrants to engage in the codes processes. These proposals would draw on the ideas outlined in the Brattle report. In particular, we intend to consult on a framework under which Ofgem would manage major policy changes by initiating and leading high level policy reviews, where the conclusions of the review would be legally binding, for example, on relevant code panels/industry participants to implement through modification proposals. In consulting on these proposals, we would propose a framework under which major reviews are undertaken on a limited basis. By way of example, projects of the nature and size of the current electricity transmission access and electricity cash out work could form the subject of future reviews.

2.12. In parallel, we will also consult on a framework which could enable Ofgem to step out of the codes decision making process on modifications that have little material customer impacts. Under this “self governance” process, Ofgem would elect, at an early stage, which modification proposals it does not wish to consider and industry would be able to take forward changes through industry led consultations and change management processes. It is possible that such a process, under which the Ofgem categorises proposals that it wishes to consider and those which can be left to self governance could produce significant efficiency and better regulation benefits. In addition, it may also be simpler and more efficient to implement as it would not involve Ofgem and industry participants having to separate the industry codes into different tiers.

2.13. It is also noted that similar self governance approaches already exist in some of the more recent industry codes such as the electricity Distribution Connection and Use of System Agreement (DCUSA).

2.14. The details (including business rules/licence changes) under which such a framework could operate in practice require development by Ofgem and consultation with industry, code administrators and other interested parties.

2.15. Over the coming months, we will develop a consultation paper setting out some options for industry to evaluate and comment upon.

⁵ The Brattle/Simmons and Simmons report contains some comparative analysis of resources devoted by industry participants to the codes governance process which indicates that substantially greater resources are devoted to these processes by the 6 largest suppliers relative to small suppliers and large customers.

Self governance - checks and balances

2.16. In consulting upon a self governance framework, the Authority would wish to ensure that such a process, if created, incorporated suitable checks and balances in order to protect the interests of new entrants, customers and competition. For example, this could take the form of an appeal mechanism enabling parties to appeal modifications to Ofgem.

2.17. We consider that it will be particularly important for all parties to have an appropriate voice in any self governance arrangements. Therefore, we will also consult on whether we should place requirements on code administrators and/or panels to consider the needs of smaller participants and new entrants should the modification process be revised. This could, for example, involve assisted funding of small party participation in code modification processes, based on industry contributions, or more practical measures to reduce the resource commitments, such as more off-line rather than meeting-bound development of proposals. We will also explore placing specific obligations on code panels to have particular regard to the interests of new and potential entrants and smaller parties in developing and assessing modification proposals.

2.18. Similarly, in consulting upon the establishment of a self governance framework, we also wish to consider the extent to which customers are adequately represented on code panels. Whilst some of the codes have voting customer representatives on code panels, there are others that do not (e.g. the Uniform Network Code). Adequate representation of customer interests would represent a potentially important check and balance to the introduction of self governance.

Major reform initiatives and self governance - a consultation package

2.19. The Authority has also emphasised that the introduction of any self governance arrangements (should this occur following consultation) should be **regarded as a package** with changes which would enable the Authority to lead and manage major policy reviews with legally binding conclusions. The Authority considers that the introduction of any self governance arrangements brings with it some risks that the codes develop in a manner that fails to promote competition and protect customers' interests. The Authority therefore considers that the ability to initiate major policy reforms would, if implemented following consultation, represent an important check and balance to address any such self governance risks.

Charging methodologies

2.20. In Ofgem's November 2007 open letter we suggested that there may be merit in giving consideration to changing the governance underlying the charging methodologies to enable market participants to propose modifications to these methodologies. We indicated that this could possibly be achieved by transferring the methodologies into the industry codes.

Respondents' views

2.21. The majority of respondents who commented on this issue were in favour of at least looking at the issue in more detail by including it within the scope of the review. A number of respondents were also specifically in favour of including the methodologies in the codes.

2.22. There was a view that network users may have an increasing role to play in determining whether networks develop in an efficient and economic manner and the current disenfranchisement of users from raising charging changes is limiting this, and potentially impacting upon customer costs. Many considered that such a move would increase transparency and inclusiveness.

2.23. Those that were against including this issue within the scope of the review considered that such a move may subject methodologies to constant change with impacts on market certainty. Concerns were also raised that it would lead to an increase to industry workload, and impinge on the network operators' commercial freedom, increasing regulatory risk and cost of capital. Some considered current processes were working sufficiently well.

Brattle views

2.24. Brattle recognises that there are advantages associated with bringing charging methodologies into the industry codes (e.g benefits in facilitating change). However, it indicates that there are also downsides in terms of increased risk for networks owners and increased resource implications for Ofgem and the industry. Brattle also notes that Ofgem already has levers to influence changes in charging methodologies, including via licence enforcement. Brattle therefore does not recommend making the charging methodologies subject to code governance.

The Authority's conclusions

2.25. Having assessed all the respondents' views, the Authority considers that there is merit in initiating a consultation on whether to make charging methodologies more accessible and subject to change by market participants and customer representatives.

2.26. As was outlined in Ofgem's November letter, the charging methodologies and the network charges which they generate can have major impacts on the decisions of market participants. In the short term, network charging methodologies can influence operational decisions of market participants and in the long term they can influence infrastructure siting decisions. Given that charging methodology changes can have impacts on short and long term decisions of market participants, they are also likely to have impacts on renewable generator behaviour and greenhouse gas emissions. In addition, changes to methodologies can also have significant distributional effects. Given these broader impacts there are strong arguments that

market participants should have the ability to propose changes to these methodologies.

2.27. The Authority considers that opening up the charging methodologies to change by industry participants could potentially increase the transparency and the design of these methodologies with consequential benefits to customers. It may also encourage debate on the appropriateness and robustness of methodologies and therefore make the networks more accountable for the methodologies that they develop.

2.28. There are two potential options for change that Ofgem intends to explore which include transferring the methodologies in the industry codes and an alternative option of retaining them within the licence framework but enabling broader market participants to raise changes.

2.29. To the extent that the methodologies were transferred into the codes it may also enable many of the economic issues surrounding cost reflectivity of transmission and distribution charging to be tested, on appeal to the Competition Commission through the codes modification appeals process.

2.30. The Authority recognises that there are potential downsides associated with introducing these reforms, many of which have been identified by respondents and are set out above. However, on balance, given that there is support from industry for considering this issue, we have decided to initiate this work-strand. Further, there may also be options available to limit the risks that the methodologies would be subject to constant change. These could involve initiatives that seek to limit change to the methodologies each year.

2.31. In recognition of the potential downsides, Ofgem also intends to consult on retaining the existing status quo - a "no change" option.

2.32. Ofgem will publish an open letter consultation setting out the various options. We expect to issue this letter in August 2008.

Code objectives

2.33. In Ofgem's November open letter we suggested that it may be appropriate to consider whether additional objectives are needed to supplement the existing code objectives so that they are aligned with the Authority's broader decision making framework. We indicated that under the current objectives there exists a risk in the Authority being required to take decisions on modification proposals that have not been informed by industry and code panel consideration.⁶

⁶ Other than in those cases where Ofgem undertakes an Impact Assessment which addresses broader issues such as the environment and sustainability.

Respondents' views

2.34. A large number of respondents commented on this issue and, in general, were either in favour of progressing alignment of objectives or at least considering it further within the scope of the review. Many of these acknowledged that in light of the changing statutory framework, the scope of the objectives should at least be reconsidered to look at issues from the environment to security of supply and customers.

2.35. Those that were not in support of including this issue within the scope considered that the current objectives were working sufficiently well to not justify the practical workload of overhauling licence and code powers to allow closer alignment. Others considered it was appropriate that Ofgem should pick up sustainability issues in its impact assessments rather than within the industry processes, since they were public policy concerns rather than industry ones. Related to this, some respondents recognised that sustainability objectives may conflict with existing efficiency objectives and they would need to understand how such a conflict would be resolved.

2.36. Many considered Ofgem should issue guidance either on the interpretation of the objectives or on the relative weightings panels and working groups should give the respective objectives.

Brattle views

2.37. Brattle's views on the code objectives are set out in the discussion of its proposals governing the introduction of a process to facilitate major reforms combined with a self governance framework. Brattle concludes that the code objectives should be more aligned with the Authority's statutory duties thereby helping to ensure that industry assessments were against the same criteria as the Authority's. Brattle note however that it might not be reasonable to expect industry participants to make value judgements on broader policy matters which the Authority is required to consider, such as consumer protection, the environment and sustainability. Brattle notes that to the extent that there is a shift towards a greater self governance framework, it would be safe for the code objectives to correspond to a commercially focussed subset of the Authority's duties. This is because the decisions taken under a self-governance framework would be more commercial in nature, where Ofgem's wider duties are less likely to have material implications for the decision.

The Authority's conclusions

2.38. The Authority recognises that there is a mis-alignment between the code objectives and the Authority's duties and principal objective which in some instances results in the Authority taking decisions on modification proposals against criteria that have not been assessed by industry participants and code panels.

2.39. On the other hand, there are several arguments to suggest that the code objectives should not be aligned to the Authority's duties and principal objective. For example, many of the criteria that the Authority has regard to in making modification decisions relate to broader public policy issues rather than commercial issues such as efficiency and competition which are considered under the code arrangements.

2.40. In addition, it is also important to note that, in most cases, the existing code objectives have origins in the statutory duties of the network owners and operators, rather than those of the Authority and that to change the relevant objectives may in turn require changes to the statutory duties and/or licence obligations of the network owners. Further, experience of the existing code objectives is that they have worked well in establishing an appropriate analytical framework for both industry participants and Ofgem to consider code modification proposals.

2.41. For these reasons, at present, the Authority does not believe that there is merit in consulting on aligning all of its statutory duties or its principal objective to the code objectives. For example, the Authority considers that issues relating to consumer impacts, social matters, safety and security of supply are primarily public policy and public interest matters that are more appropriately considered by the Authority as opposed to commercial matters in which the industry has expertise.

Treatment of environmental issues

2.42. However, the Authority believes consideration should be given to whether the industry's decision making criteria on modifications should be amended so that it is required to take into account environmental issues when evaluating modification proposals.

2.43. Ofgem has issued its Final Clarification and Guidance to code panels and industry participants on the treatment of the costs of greenhouse gas emissions under the **existing code objective governing efficient and economic network operation**. The Authority considers there is merit in building on this to explore whether code panels and industry should have wider responsibilities to assess environmental impacts. This could potentially bring benefits associated with aligning industry assessments with the Authority's own decision making process.

2.44. In considering these issues we intend to explore whether to expand the scope of the existing code objectives or alternatively introduce a new general environmental objective which may encompass more than an assessment of greenhouse gas impacts. Our consideration of these matters is likely to raise complex issues. For example, it might entail a consideration of how Ofgem and code panels/industry should address trade-offs between efficiency and the attainment of broader environmental goals and how such an objective would relate to the general licence and statutory duties of network owners. Such issues will need to be considered through a comprehensive consultation process.

2.45. We would also intend to explore more light-handed options including a requirement on the code panels to consult on environmental issues in the context of

modification proposals and to report to the Authority on the outcome of any such consultation.

2.46. We will therefore initiate a work-strand which consults on these issues further and will publish an open letter consultation setting out a number of options reflecting the discussion set out above. We intend to publish this open letter in September 2008.

Role of code administrators and code panels

2.47. In our November 2007 letter we raised concerns regarding the quality and depth of analysis provided in code modification reports. We also indicated that modification reports and consultation documents do not make sense on a standalone basis and lack an effective and critical assessment of modification proposals. We raised concerns regarding the effectiveness of workgroup processes, including whether they were disenfranchising participants from the modification process.

Respondents' views

2.48. Several respondents considered that improvements in this area would be gained by changes to Ofgem's operational practices and terms of engagement with the industry on the modifications process. Some considered that any gaps in evidence could be picked up in Ofgem's regulatory Impact Assessments.

2.49. There were suggestions that incentives could be introduced to provide better evidence, with Ofgem rejecting more modifications that were not properly substantiated, or by placing greater burdens on those proposing modifications to produce better evidence of the need for change before a proposal could be accepted into the process.

2.50. Many smaller industry participants perceived this as a serious issue, noting that some modification reports are incomprehensible. There were suggestions that there should be a set of minimum standards for evidence and materials to be generated by the industry modification process.

2.51. There was a suggestion that independent consultants should be employed to conduct cost/benefit and/or other analysis on issues where modification groups were unlikely to provide effective analysis due to commercial sensitivities.

2.52. Another suggestion was that code administrators should be required to better challenge evidence and views rather than simply report them. Alternatively, a respondent considered that Ofgem should actively manage the quality of modification reports and have the ability to send reports back for further work if deemed necessary.

2.53. We also received a number of more general comments regarding the role and governance of the code administrators. Some respondents commented that Ofgem should consider whether all code administrator roles should be subject to periodic tenders. Comments were also received that the number of code administrators should be reduced and that performance of administrators be subject to benchmarking. It was also suggested that the code administrators should be made entirely independent of the network owners.

Brattle views

2.54. Brattle has concluded that the quality of modification assessments delivered to the Authority is not always of sufficiently high quality, particularly when a proposal involves significant policy changes that require objective analysis. Brattle comments that the complexity of the code arrangements and the poor levels of analysis make understanding issues unnecessarily opaque which creates difficulties for smaller players. Brattle has also identified areas where the efficiency of the code process could be improved. Brattle does not however propose introducing incentive schemes on code administrators to improve their performance. However, it believes consideration should be given to measures that enable the Authority to send back deficient modification reports and demand more expeditious progress on modifications that it considers are taking too long to progress.

2.55. Brattle also comments that initiatives (discussed below) to facilitate code convergence may enable more benchmarking of administrators. In addition, they comment that the introduction of more self governance might increase pressure from industry on code administrators to provide cost efficient, high quality services.

The Authority's conclusions

2.56. The Authority has received a broad range of comments on issues associated with the role and governance of code panels and code administrators, which extend beyond the preparation of modification reports and the management of workgroups. In this section we therefore address these broader issues as well as those surrounding quality of modification analysis.

Quality of analysis

2.57. The Authority continues to hold significant concerns surrounding the quality of analysis undertaken through the modification processes. The Authority is particularly concerned by the difficulties faced by new entrants and smaller players, given the complexity and opaque nature of code modification reports. These concerns also extend to customers and customer representatives who equally face difficulties in understanding developments in the code arrangements. Similarly, the lack of critical assessment and analysis in some reports make it difficult for the Authority to assess the merits of modification proposals.

2.58. We do not agree with respondents who have suggested that the Authority undertakes more of its own analysis through Impact Assessments. We do not consider that Ofgem Impact Assessments should act as a substitute for industry analysis, particularly as Impact Assessments are intended only to be undertaken on exercises of Authority functions that are “important” under the Energy Act 2004.

2.59. Indeed, to the extent that more self governance is introduced as a result of the initiatives outlined above, we consider that it would become even more important for industry participants and code panels to ensure that they are effectively analysing modification proposals against the relevant code objectives.

2.60. We accept that there is a role for Ofgem, where possible to provide assistance to code panels in defining the analysis that needs to be undertaken. Similarly, there is scope for Ofgem representatives to advise industry participants or code panels on the merits or otherwise of particular policies without prejudging or fettering the views of the Authority.⁷ Ofgem will therefore try and provide assistance and advice, however it is important to recognise that this will not always be possible as there may not always be sufficient resources available, particularly given the substantial number of modification proposals raised across the codes each year.⁸

2.61. In view of the concerns set out above, we are proposing to issue a consultation on measures to improve the performance of code panels and administrators on the quality of analysis they provide. Building on the comments we have received from industry participants, this includes consulting on measures that would enable the Authority to “send back” modification assessments that are deficient in terms of quality of analysis. We will also consult on measures that would enable the Authority to “call-in” code panels and/or administrators where progress in developing modification proposals has been slow or where analysis is not being performed. We will also consult on requirements for code panels to give clear and transparent reasons for their recommendations to the Authority on modification proposals. We are planning to issue this consultation in the autumn of 2008.

Governance of code administrators and panels

2.62. We have set out our concerns regarding the ability, more generally, of smaller participants and new entrants to engage in the code arrangements. The Authority considers that there are broader amendments to the governance of the code panels and administrators that could be explored and consulted upon to address these concerns.

2.63. In particular we will consult on:

⁷ We would note in this respect that there is also scope under several of the industry codes for Ofgem to issue provisional views on modification proposals.

⁸ By way of example, Ofgem decided upon in excess of 150 proposals last year.

- improvements that can be made to the governance structures of the code administrators and panels. We consider that there is merit in exploring the introduction of independent company and board structures for the administration of the major commercial codes such as the UNC and CUSC which do not currently have them and in reviewing the governance structures of the other major commercial code, the BSC. We consider that this may improve the accountability of administrators in terms of costs and quality of services and more generally, in the delivery of the code objectives. We do not intend to review the board or governance structures of those independently owned administrators who have been appointed via a service contract (e.g. GEMSERV or Electralink). We do not intend to explore the creation of independent board structures for the administration of the Grid Code or the Distribution Code;
- whether Ofgem should undertake benchmarking of the code administrators to compare their costs and service delivery, with a view to making them more accountable;
- whether there is merit in introducing independent panel chairs for those codes that do not currently have them; and
- whether customer representation rights on code panels should be aligned across all codes, such that designated customer representatives have the rights to vote on proposals and raise modification proposals under all codes.

2.64. At this stage, we do not intend to explore introducing price controls or service contract arrangements for those administrators who do not have them. We do not consider that there was sufficient support from respondents to initiate major reforms of this nature. However, it should be noted that there is nothing to stand in the way of industry participants seeking to initiate reforms of this nature in the future.

Reducing fragmentation and complexity

2.65. In our November 2007 open letter, we sought views on whether there were issues relating to the fragmentation and complexity of the codes arrangements that should be considered as part of the review.

Respondents' views

2.66. Several respondents commented upon the complexity of the codes arrangements. A number of respondents expressed concerns regarding fragmentation and some considered that there was merit in exploring convergence and harmonisation of code rules as a means of reducing fragmentation and complexity. Related to this, some suggested that best practice features should be identified across the codes. Some respondents also suggested that Ofgem should explore code or code administrator mergers (e.g. BSC and CUSC). As noted above, some respondents have commented that cross-code processes do not work well and that there may be merit in exploring solutions to this.

2.67. Several other respondents however were opposed to fundamental change in the governance arrangements, raising concerns at the associated costs and commitments that would be required from industry participants. Others emphasised the need for cost/benefit analysis to be performed on any fundamental change to the governance arrangements.

Brattle views

2.68. Brattle has commented that code fragmentation adds a heavy layer of additional complexity to the arrangements and provides a barrier to participation by smaller players. Brattle does not recommend pursuing code mergers but does recommend streamlining of the code arrangements so as to minimise the complexity of dealing with different administrative procedures for each code. Brattle indicates that it would be sufficient to ensure that the different administrators all follow a set of uniform processes.

The Authority's conclusions

2.69. The Authority considers that the fragmentation of the codes governance arrangements, particularly in the electricity sector, adds additional complexity for market participants and represents a barrier to new entrants and small suppliers engaging in codes processes. In particular, as a result of the fragmentation of governance arrangements such as those in the electricity sector where there exist 7 different codes, market participants need to understand and devote significant resources to each process to be able to engage in and influence policy outcomes. If smaller participants and new entrants experience difficulties in committing resources to these codes then they are less likely to raise code changes, which may bring pro-competitive benefits.

2.70. The Authority however recognises that initiating code mergers or mergers of code administrators is likely to be a substantial and resource intensive exercise, both for Ofgem and industry participants who would need to be involved. Based on the responses received to the governance review, in particular the November 2007 consultation, the Authority considers that there is insufficient support, at this time, from industry participants to pursue code mergers, notwithstanding the benefits that may arise.

2.71. Nevertheless, the Authority believes that there is merit in industry participants in exploring the potential for simplification and convergence of code modification processes in order to reduce complexity and encourage best practice across the codes. The Authority considers that this could provide benefits to new entrants and therefore, indirect benefits to competition. **We will therefore establish an Ofgem chaired working group with the code administrators (and other interested parties) to explore and progress opportunities for the convergence of code modification processes.**

Specific small participant initiatives

2.72. Many of the work-strands outlined above could help to assist smaller participants such as smaller suppliers and renewable generators to engage better in the codes processes, as well as those representing customer interests. In particular, we consider that these participants could benefit from convergence of code rules, improvements in quality of analysis, as well as our programme of work on addressing major policy reforms.

2.73. However there are other initiatives that we intend to explore further and consult upon, building on some of the recommendations in the Brattle report. These initiatives include:

- Whether there are requirements that should be placed upon code administrators or code panels to consider the needs of smaller participants and new entrants in the administration of the codes modification process
- Whether a central industry based fund or some other form of assistance should be established to assist smaller participants in engaging in the codes modification process. This could enable smaller parties to draw upon resources that would help them participate in code change working groups or indeed, assistance in the development of modification proposals.

3. Way Forward

Timing and consultation process

3.1. The indicative timing of the various work-strands has been set out in summary form in Appendix 2. Each of the various work-strands will be taken forward through a combination of consultation documents and workshop discussions. As noted in Chapter 3 the "Complexity and fragmentation" work-strand will be taken forward through an Ofgem facilitated working group.

3.2. Given the number of work-strands and the nature of the issues we expect this work programme to progress at least over the next 12 month period. Over the coming weeks, Ofgem intends to attend the panel meetings of the various industry codes to outline the proposals and take questions from industry participants.

3.3. It is important to emphasise that there is a significant level of consultation and analysis required under each of the work-strands outlined in Chapter 2. This will require clear definition of options and assessment of these options. In assessing the options Ofgem will use the objectives for the review as set out in its November 2007 letter, where we stated that in our view an good 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.

3.4. Ofgem will also consider whether to undertake impact assessments against any options that are set out for each work-strand. Ultimately depending on the conclusions it is possible that code and licence changes will be required to implement the chosen options, should this occur following consultation.

3.5. In setting the scope of the review, the Authority has been conscious of the level resource and commitment required for both Ofgem and the industry. Indeed in some cases the Authority has concluded that there is insufficient industry support (given the level of resources required) to take forward initiatives.

3.6. For those work-strands we have decided to initiate, the Authority would encourage and welcome the input and commitment of the industry towards building a better codes governance regime. Indeed, over the coming weeks Ofgem will seek to initiate discussions with industry participants and code panels on the work-strands set out in this letter.

3.7. We also intend to keep industry participants up to date on the progress of the review through the codes governance review link on the Ofgem website.⁹

⁹ <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>

Appendices

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Appendix 1 - List of respondents

List of Non- Confidential Respondees

List	Name
1	Association of Electricity Producers
2	Airtricity
3	Bizzenergy
4	British Energy
5	BSC Panel
6	BWEA
7	CE Electric
8	Central Networks
9	Centrica
10	DCUSA Panel
11	Drax
12	EdF
13	Electralink
14	Electricity North West Limited
15	ELEXON
16	ENA
17	Energywatch
18	Eon
19	Gaz de France
20	Good Energy
21	Grid Code Review Panel
22	GTC
23	Highlands & Islands Enterprise
24	IGT UNC
25	International Power
26	Joint Office
27	London Climate Change Agency
28	MRA Executive Committee
29	National Grid
30	NGN
31	Nigel Cornwall
32	RWE Npower
33	Scottish Power
34	Scottish Renewables
35	SPAA Executive Committee

36	SSE
37	Statoil UK
38	STC Committee
39	The Gas Forum
40	The Scottish Government
41	UNC Panel
42	Western Power Distribution
43	WWU

Summary of Responses

Responses received by Ofgem which were not marked as being confidential have been published on Ofgem's website at:

www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=3&refer=Licensing/IndCodes/CGR.

Copies of non-confidential responses are also available from Ofgem's library.

Appendix 2 – Indicative timetable

WORK-STRAND DESCRIPTION	NEXT STEP
Charging methodology governance	Open letter consultation – August 2008
Environment and the code objectives	Open letter consultation – September 2008
Role of code administrators and smaller participant initiatives	Consultation - Autumn 2008
Major policy reviews and self governance	Consultation – Autumn 2008
Code administrators working group	Ofgem to convene working group – August 2008

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.¹⁰

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 accordingly¹¹.

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 them¹²; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.¹³

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:

¹⁰ entitled "Gas Supply" and "Electricity Supply" respectively.

¹¹ 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.

¹² 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.

¹³ The Authority may have regard to other descriptions of consumers.

-
- Promote efficiency and economy on the part of those licensed¹⁴ 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 Regulation¹⁵ 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.

¹⁴ or persons authorised by exemptions to carry on any activity.

¹⁵ Council Regulation (EC) 1/2003

Appendix 4 - 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:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- 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?
- Please add any further comments?

1.2. Please send your comments to:

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