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Our Reference:
Your Reference:

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Dear Mark,

**Code Governance Review: Charging Methodology Governance Options**

We welcome Ofgem's review of industry code governance and, in particular, the opportunity to respond to the above consultation paper. In our view, securing the proper treatment of charging methodologies is key to the success of the review.

We strongly support the principle of opening up transmission charging methodologies to change by network users and customers. In addition, we believe that there is a clear case for moving the charging methodologies into, and made subject to, the governance arrangements of the existing codes (Option 3 in the paper) and we set out our reasons for this in more detail below. We have also set out our answers to Ofgem's specific questions and the cost questionnaire in the attached Appendix.

*Opening up charging methodologies to change by market participants and customer representatives*

As Ofgem recognise in the paper, the charging methodologies can and do have a number of significant impacts on market participants (and ultimately customers). In particular, the methodologies have vital distributional effects across different categories of user, according to their pattern of use and their location on the network.

For example, the charging arrangements in both electricity and gas transmission impose costs of some £1.7bn on the market. The costs that individual customers are exposed to can vary significantly year-on-year (we have seen year-on-year increases in charges of over 130% at certain sites). There is also growing evidence that in some cases transmission charging methodologies are not cost reflective and are having a detrimental environmental impact. In the electricity market they are acting against the efficient deployment of new and renewable generation. Despite these concerns, there is presently no direct involvement by market participants in putting forward change proposals to the methodologies.

Against this background, we strongly support Ofgem's view that due to the significant impact charging methodologies have on network users and customers, there is considerable merit in opening up the charging methodologies to change by network users and customer representatives. In our view, any such change in governance would need to be subject to the appropriate safeguards being put in place to protect against increased costs, price volatility and revenue volatility to the network operator businesses (NWOs). We discuss the different options for opening up the charging methodologies and appropriate safeguards in turn below.

*Options*

Ofgem's paper sets out four possible options for dealing with the governance of charging methodologies: maintain status quo; modify the current licence regime; modify existing industry code governance; and a new charging methodology change management code. The paper then assesses each of these options in comparison to the status quo (Option 1) using the principles of good governance set out in Ofgem's June 2008 decision on the scope of the review.

We broadly agree with Ofgem's assessment of the different options which, in our view, demonstrates that Option 3 (modify the existing industry code governance arrangements) would deliver the most benefit at least cost. Under this option, charging methodology changes would become subject to Code Panel assessment procedures and Code Panel recommendations. In addition, Authority decisions on charging methodology modification proposals would become appealable to the Competition Commission where these decisions diverged from Panel recommendations.

Given that the charging methodologies carry, in many cases, a far greater impact and/or risk to parties (with potentially significant consequences for competition) than other changes arising out of the Codes, it is absolutely vital that any decision to open up the charging methodologies to network users and customer representatives is coupled with the same rights of appeal as apply to other changes to the Codes. Only Option 3 would provide an equivalent right of appeal to the Competition Commission and thus in our view provide the necessary degree of accountability for decisions made in relation to the charging methodologies.

As Ofgem recognise, Option 3 would also deliver considerable benefits in terms of increased accessibility and inclusivity and the change processes would be administered in a more independent, objective and therefore robust manner. In addition, under this option the methodologies would become subject to rules and processes that are already well established and understood. This would clearly be in the interests of transparency, simplicity and cost effectiveness, particularly for smaller players. This can be compared to Options 2 and 4 which would both require a new set of consultation rules and processes to be created.

We also agree with Ofgem's assessment that greater efficiencies could be achieved under Option 3 by bringing the charging methodologies within the scope of the individual Codes, compared to Options 2 and 4. This would allow assessment of consequential Code modifications to be considered simultaneously with charging methodology changes and vice versa, thus increasing efficiency and minimising duplication of effort. We therefore believe that there is a clear case for moving the charging methodologies to within the scope of the appropriate Codes i.e. Option 3.

*Potential risk mitigation measures*

Notwithstanding the above, we agree with Ofgem that there are risks associated with opening up the charging methodologies to market participants and customer representatives including a potential increase in change administration costs, uncertainty and pricing volatility. In addition, it could create increased revenue volatility for the NWO businesses and increase the risks of over/under recovery occurring (resulting in NWOs being penalised for breach of price control licence conditions). However, we believe appropriate safeguards can be put in place to protect against these risks and in particular to provide NWOs with a reasonable degree of certainty on revenue recovery.

We believe that the most appropriate measure to mitigate the risk of price and revenue uncertainty would be to introduce bi-annual change implementation dates (say, 1st April and 1st October). Under this measure, change proposals could be raised at any time during the year but, if approved, they would not take effect until the next feasible implementation date. This would allow sufficient time for a thorough assessment of change proposals while also spreading the cost and resource required for such assessments across the year (a window for change proposals could lead to a flood of proposals requiring to be assessed within a relatively short period of time). This approach may require a change to some licences (for example, the GDNs' licences only allow changes to their charging methodologies once a year) but would be consistent with a number of the existing codes and customer contract rounds.

Bi-annual implementation dates would also assist NWOs in managing their within year revenue risks which would in turn minimise the risk of revenue volatility. The more significant the change, the longer the lead time before implementation would be required in order to minimise the risk of price volatility. This would also provide network users with sufficient notice of upcoming changes, thus helping to address Ofgem's concerns regarding large step changes in charges on an annual basis. Moreover, under Option 3 any changes would be subject to industry assessment via existing Code Panels and governance processes. Also, we believe that moving administration responsibility away from NWOs has the added advantages of increasing objectivity and improving the checks and balances in the process.

Ofgem propose two other possible risk mitigation measures: annual restrictions on the number of changes and modification proposal thresholds for network users. We do not support either of these measures as we believe that they go against the overall principle of opening up the charging methodologies to *all* market participants and customer representatives and, in particular, operate against the interests of new and smaller market participants. A view may still be valid even if it is a minority view; this principle is embodied within a number of areas of regulation e.g. the Collective Licence Modification process. We do not therefore believe that either of these two measures should be implemented.

*Approach*

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

*Conclusion*

In conclusion, therefore, we strongly support opening up the charging methodologies to change by network users and customer representatives. In addition, we believe that there is a clear case for moving the charging methodologies into the governance arrangements of the existing codes (Option 3), subject to appropriate safeguards being implemented to protect against increased costs and risks to the NWOs. We believe that the most appropriate means of doing this would be to introduce bi-annual change implementation dates. Finally, in taking these proposals forward, we would urge Ofgem to focus on Transmission methodologies in the first instance, given their GB application, the scale of the costs and their potential to create significant windfall gains and losses for individual market participants.

I hope the above comments are helpful. If you wish to discuss any of the above further, please do not hesitate to call.

Yours sincerely

Rob McDonald
**Director of Regulation**

## Appendix:  Specific Questions and Cost Questionnaire

**Specific Questions**

Chapter Two

*Question 1:  Are there other key issues that should be considered?  If so what impact would these issues have on NWOs and networks users?*

In our view, the paper considers the key issues relevant to changing the charging methodology governance arrangements.

*Question 2:  Are there any aspects of the key issues that we have not addressed?*

No.

*Question 3:  Should Ofgem consider governance arrangements for all charging methodologies on a common timetable, or seek to prioritise?  If the latter, which methodologies do you consider should take priority and what would the benefits of this approach be?*

We believe that Ofgem should consider the Transmission charging methodologies in the first instance, given their GB application, the scale of the costs and their potential to create significant windfall gains and losses.  However, this would not preclude Distribution charging methodologies being placed within a similar governance arrangement in the longer term.

Chapter Three

*Question 1:  Are there alternative governance arrangements that could be considered appropriate for charging methodologies?*

As we have stated above, we believe that there is a clear case for moving the charging methodologies into, and made subject to, the governance arrangements of the existing codes (Option 3).

*Question 2:  Do you agree with our assessment of the options against the principles of the Review.  Are there other impacts that we have not mentioned?*

We broadly agree with Ofgem's assessment of the different options which, in our view, demonstrates that Option 3 would deliver the most benefit at least cost.

*Question 3:  What are your views on the cost and risk mitigation measures set out in this chapter?  Are there other mitigation measures that could be introduced?*

We believe that the most appropriate measure to mitigate the risks would be to introduce bi-annual change implementation dates, say 1st April and 1st October.  Under this measure, change proposals could be raised at any time during the year but, if approved, they would not take effect until the next feasible implementation date.  This would allow sufficient time for a thorough assessment of all change proposals, helping to minimise costs where there are common issues to be addressed, while also spreading the cost and resource required for such assessments across the year. This approach would be consistent with a number of the existing codes and customer contract rounds.

Bi-annual implementation dates would also assist NWOs in managing their within year revenue risks which would in turn minimise the risk of revenue volatility. The more significant the change, the longer the lead time before implementation would be required in order to minimise the risk of price volatility. This would also provide network users with sufficient notice of upcoming changes, thus helping to address Ofgem's concerns regarding large step changes in charges on an annual basis.

**Cost Questionnaire**

<u>Questions for NWOs</u>

*Question 1*

In our view, the most significant potential impact of opening up the charging methodologies to change by network users and customer representatives would be the increase in administrative costs arising from both the increase in the number of modifications and the assessment required for the additional modifications. However, we believe that Option 3 (coupled with bi-annual change implementation dates) would minimise the increase in costs associated with such a change in governance.

*Question 2*

It is clear that opening up the charging methodologies to change by network users and customer representatives would lead to a potentially significant number of modification proposals being raised which would, in turn, lead to an increase in administrative costs. In our view, a reasonable increase in administrative costs would be acceptable given the benefits that would be realised from such a change. In addition, we firmly believe that Option 3 (modifying the existing industry code governance arrangements) would be the most cost effective option for change as the rules and processes are already well established and understood by industry. This can be compared to Options 2 and 4 which would both require a new set of consultation rules and processes to be created and implemented.

*Question 3*

We do not foresee a significant impact on NWO businesses in terms of price certainty or regulatory uncertainty from any of the options for change set out in the paper, subject to being able to recover the allowed revenue provided for in our price control. However, too many changes to the methodologies could increase uncertainty for users, lead to price variations across user categories and result in a significant increase in administrative costs which could have a negative impact on the level of project investment. It is therefore vital that the appropriate safeguards are put in place to minimise the risk to project investment and allow NWOs to recover their allowed revenue.

To this end, we would support the introduction of bi-annual change implementation dates (1st April and 1st October) where change proposals could only be implemented on these pre-determined dates. This approach would provide NWOs with sufficient notice of upcoming changes, minimise volatility and administrative costs, and would assist NWOs in managing their within year revenue risks. It would also be consistent with a number of the existing codes and customer contract rounds.

*Question 4*

We believe that Option 3 (coupled with bi-annual change implementation dates) poses the least risk to NWOs business activity as it represents the most cost effective and pragmatic option for opening up the charging methodologies to network users and customers.

Questions for network users and customers

*Question 5*

We estimate that we would have raised one modification to the charging methodologies within the last year.

*Question 6*

Opening up the charging methodologies to change by network users and customer representatives would lead to a potentially significant number of modification proposals being raised which would, in turn, lead to an increase in administrative costs. In our view, a reasonable increase in administrative costs would be acceptable given the benefits that would be realised from such a change. In addition, we firmly believe that Option 3 (modifying the existing industry code governance arrangements) would be the most cost effective option for change as the rules and processes are already well established and understood by industry.

Scottish & Southern Energy
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