

## Code Governance Review: Major Policy Reviews and Self Governance

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### Overview:

The industry codes provide a contractual framework containing most of the technical and commercial rules by which the gas and electricity industries operate. Recognising that those markets have matured and the nature of participation has evolved, the Code Governance Review ("the Review") aims to ensure that the codes are able to respond to the significant challenges currently facing the gas and electricity industries.

In June 2008 we released our decision on the scope of the Review and indicated we would consult on proposals to reform the codes arrangements to facilitate the **delivery of major policy reform on codes issues and the introduction of more Self Governance**, as part of a package of measures. In this document we consult on two significant additions to the existing code governance arrangements. First, the ability of Ofgem to initiate Major Policy Reviews, one possible outcome of which could be an obligation on industry/code panels to raise appropriate code modification(s). We are also consulting on proposals for code modifications that pass certain criteria (i.e. those which are unlikely to have significant impacts on consumers or on competition) to be assessed through a new Self Governance process, with industry participants rather than Ofgem making the final decision on modification proposals.

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The Authority is committed to policies and processes that are consistent with better regulation principles and that reduce the administrative burden on business while maintaining effective consumer protection.

As part of that commitment, in November 2007 we announced the Industry Codes Governance Review. The industry codes provide a contractual framework containing most of the technical and commercial rules by which the gas and electricity industries operate. We considered that such a review was timely given the changes that have occurred in those industries, where the nature of market participation is changing, particularly with respect to new entrants and smaller players. The Authority's role in relation to code modifications has also changed as a result of additions and changes to its statutory duties and the right of appeal to the Competition Commission.

In June 2008, we set out the scope of the Review and confirmed that a good governance regime should –

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

The Industry Codes Governance Review is considering what changes are required to deliver these objectives. The review comprises several work-strands which are listed in the table below.

<b>Work-strand</b>	<b>Update</b>
Major Policy Reviews and Self Governance	Ofgem consultation issued today – Responses due 27 February 2009.
Charging methodologies	Ofgem consultation issued September 2008 – Responses due 16 January 2009
Code objectives and the environment	Ofgem consultation issued November 2008 – Responses due 16 January 2009
Complexity and fragmentation – Code Administrators Working Group	Five meetings have occurred to date. Due to issue draft report February 2009. Further details can be found on Ofgem's website at <a href="http://www.ofgem.gov.uk">www.ofgem.gov.uk</a>
Role of Code Administrators and small participant/consumer initiatives	Ofgem consultation issued today – responses due 27 February 2009

This document is related to the work-strand covering the delivery of Major Policy Reviews and Self Governance.

- 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](http://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](http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/CORPORATE%20STRATEGY%20AND%20PLAN%2028%20MARCH%202008.pdf)

- Review of industry code governance - scope of review: 92/08, June 2008:

[www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/GovRevScope%20-%20MF%20Final%2030%20JUNE%2008.pdf](http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/GovRevScope%20-%20MF%20Final%2030%20JUNE%2008.pdf)

- Code Governance Review: Charging methodology governance options, Ofgem, Ref: 132/08

[www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/CGR\\_CM\\_Sept\\_FINAL.pdf](http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/CGR_CM_Sept_FINAL.pdf)

- Review of Industry Code Governance – Environment and Code Objectives, Ofgem Open Letter, 21 November 2008

[www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/open%20letter%2020%20November%20draft%20\\_4\\_.pdf](http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/open%20letter%2020%20November%20draft%20_4_.pdf)



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## Summary

This document sets out Ofgem's consultation on proposals for the delivery of major policy reform and Self Governance under the industry codes. This consultation forms part of Ofgem's ongoing review of industry code governance arrangements and was signalled in the Gas and Electricity Market Authority's ('the Authority') June 2008 decision on the scope of this review ('the June document').

Over recent years the codes arrangements have worked well to deliver incremental reforms. However, with the increasing emphasis on sustainable development, the nature of participation in the electricity and gas sectors is changing with the entry of smaller renewable participants and smaller suppliers. In addition, the nature of the regulatory issues facing industry participants, Government and Ofgem is becoming more challenging in the face of climate change and, from a security of supply perspective, Great Britain's increasing dependence on external energy sources.

Recently the code governance arrangements have been severely tested in two key strategic reform areas that are significantly impacted by public policy issues including sustainable development and security of supply. These reform areas are electricity transmission access and electricity cash out. In both these key strategic areas progress under the codes arrangements has been difficult to achieve. We consider that the difficulties and delays in the delivery of strategic reforms also mean that the benefits to consumers of reforms are not delivered or are delayed. The delays and difficulties that have been experienced have been caused by a variety of factors such as piecemeal modification proposals being raised at different times as well as significant divergences in the views of industry players on the nature of reforms. Since the typical time for a code panel to progress a major modification is around 200 days, a piecemeal approach adds significantly to the length of time required to achieve a coherent set of reforms.

We have also been concerned that the current codes arrangements are complicated and make it difficult for new entrants and small players to engage in and influence major and strategic policy debates. These players often do not have the resources to match those of the larger incumbent energy companies in participating in key policy debates.

The changing regulatory and market landscape suggests that there are likely to be other important strategic code reform challenges in the future. We therefore believe that it is necessary to consider major reforms to the code governance arrangements to ensure that strategic reforms can be considered and progressed in a holistic and comprehensive manner.

In the light of these challenges, there is merit in ensuring that Ofgem's resources are focussed on code issues that significantly impact upon competition and/or consumers, as well as Ofgem's other statutory duties including those governing sustainability and security of supply. At present, Ofgem deals with a large number of modification proposals that have minimal impact on consumers and/or competition and its other statutory duties. Whilst many of these are housekeeping modification proposals, there are also a significant number of other proposals that introduce

systems and process changes as well as minor governance changes that could be managed by industry without the need for Ofgem involvement.

### **Ofgem's Proposals**

We are therefore consulting on reforms in 2 key areas. First, we are proposing that significant reforms requiring changes to the industry codes could in future be developed through a new "**Major Policy Review process**". This process would be led by Ofgem, and could be initiated either when Ofgem identifies a significant policy issue or when a code modification, raised in the usual way, gives rise to significant policy issues. The outcome of the Major Policy Review could take the form of detailed policy principles and binding directions to code panels/licence holders to raise code modification proposals, or alternatively a code modification proposal prepared by Ofgem. Based on our experience to date, we would not expect to conduct more than 1-2 Major Policy Reviews each year if these proposals were implemented.

Second, as suggested above, we are proposing that code modification proposals that are likely to have minimal impacts on competition and consumers and that meet defined criteria could be dealt with through a new **Self Governance process**. All other modifications would be dealt with through a modified version of the current governance arrangements. Thus, Ofgem would make decisions only on modification proposals that are likely to have, amongst other things, impacts on competition and/or consumers. In order to deliver these reforms we are also proposing to introduce a filtering or categorisation process to determine whether modifications should follow the Self Governance route, the Major Policy Review route or a modified version of the current route.

The June document made it clear that these proposals would be consulted on as a package. This remains our position. In this document we set out proposals on the detailed framework for Major Policy Reviews and Self Governance. We also set out our initial impact assessment of the reform proposals.

### **Initial Impact Assessment**

We consider that the reform package could result in a significant improvement over the status quo because it should lead to more efficient policy making and implementation. In particular, the Major Policy Review process should help to ensure that consumers obtain the benefits of policy reforms in key strategic areas at an earlier stage. In practical terms, the introduction of a Major Policy Review process could ensure that key strategic policy issues are considered via a single process and should reduce the need for multiple piecemeal code modifications and therefore multiple assessment processes undertaken by industry, code administrators, code panels and Ofgem. We consider that the Major Policy Review process should help consumers and small participants engage in key policy debates. Further, the Self Governance arrangements represent an important improvement which could help to ensure that Ofgem resources are focussed on those issues that are more material to competition and consumers with consequential better regulation benefits. Indeed, a significant proportion of modification decisions could be addressed by Self Governance which should reduce industry costs and potentially facilitate faster implementation of change proposals.



## 1. Introduction

### Background

1.1. In November 2007 we initiated a review of the industry codes governance arrangements with an open consultation. The Industry Codes Governance Review ('the Review' ) was triggered by a number of factors, including:

- the major industry codes were introduced some time ago, and since this time there have been significant changes in the market and regulatory landscape which raise the possibility that the governance arrangements may no longer be optimal:
  - the Authority's statutory duties have changed, for example with the inclusion of, duties relating to sustainability, the environment, and better regulation;
  - certain decisions of the Authority in relation to code modifications are now subject to appeal to the Competition Commission;
  - the Authority is now required to undertake Impact Assessments before reaching certain important decisions, including in relation to some code modifications;
- the nature of the market place continues to evolve, in particular with the entry of smaller players including renewable and distributed generators; and
- concerns that have been expressed by small market participants, that the existing code arrangements are too complex and inaccessible, particularly for the smaller new entrants in the market, and more generally that there may be weaknesses in the way the codes are governed which prevent industry and consumers from getting full value from the code arrangements.

1.2. In addition to responses to the open letter consultation in November 2007, we also heard perspectives from a number of industry representatives at a Powering the Energy Debate event in February 2008. Finally, we 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 and is referred to in this document as the Brattle Critique<sup>1</sup>.

1.3. In addition to the factors which led us to launch the Review, we were also concerned that the codes arrangements have hindered progress in key areas of policy development. Cash-out and transmission access reform are two such areas.

### Scope of the review

1.4. In June 2008 the Authority published its decision on the scope of the Review ('the June document'). The Authority 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. The programme of work has six (related) work-strands.

1.5. A summary table of the various Review initiatives is set out below.

<b>Work-strand</b>	<b>Update</b>
Major Policy Reviews and Self Governance	Ofgem consultation issued today <sup>2</sup> – Responses due 27 February 2009.
Charging methodologies	Ofgem consultation issued September 2008 <sup>3</sup> – Responses due 16 January 2009
Code objectives and the environment	Ofgem consultation issued November 2008 <sup>4</sup> – Responses due 16 January 2009
Complexity and fragmentation – Code Administrators Working Group	Five meetings have occurred to date. Due to issue draft report February 2009. Further details can be found on Ofgem's website at <a href="http://www.ofgem.gov.uk">www.ofgem.gov.uk</a> <sup>5</sup>
Role of Code Administrators and small participant/consumer initiatives	Ofgem consultation issued today – responses due 27 February 2009

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<sup>1</sup> *Critique of the Industry Codes Governance Arrangements, June 2008, a report for Ofgem, The Brattle Group and Simmons and Simmons.*

<sup>2</sup> *Code Governance Review: Major Policy Reform and Self Governance, Consultation, Ofgem, December 2008.*

<sup>3</sup> *"Code Governance Review: Charging methodology governance options", Consultation, Ofgem, September 2008.*

<sup>4</sup> *"Review of Industry Code Governance, Environment and Code objectives", Open letter consultation, Ofgem, November 2008.*

<sup>5</sup> <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/CAWG/Pages/CodeAdmWorkingGroup.aspx>

## Purpose of document

1.6. In the June document we explained that we would 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, upon relevant code panels/industry participants to implement through modification proposals.

1.7. We also explained that we would consult in parallel on proposals to enable Ofgem to step out of the codes decision making process on proposals that have low customer impacts.

1.8. In line with the Authority decision on the Review as set out in the June document we are consulting on these two reforms as a **single package**.

1.9. The purpose of this document is to:

- describe the proposed package of reforms;
- consult on whether to proceed with reform;
- consult on the detailed design of the proposals; and
- consult on our initial assessment of the package of reforms, as it compares with the status quo arrangements.

1.10. Our current thinking, on which we welcome feedback from respondents, is that the package of reforms would be significantly better than the status quo arrangements. There are in addition a number of detailed design questions on which we would also welcome views from respondents.

**1.11. We would welcome written responses on this document by Friday 27 February 2009.**

**1.12. In order to help inform written responses to this document we intend to hold a work-shop on our proposals. This will be held in early February and details of the work-shop will follow shortly. Respondents interested in attending a work-shop on the issues raised in this document should contact Jenny Boothe on 0207 901 7122 or [jenny.boothe@ofgem.gov.uk](mailto:jenny.boothe@ofgem.gov.uk) by 16 January 2009.**

## Structure of document

1.13. The remainder of this document is structured as follows:

- chapter 2 sets out the key issues being addressed by our proposals, and the Authority's objectives for the reforms;
- chapter 3 describes possible arrangements for determining how code modification proposals would be managed under a reformed framework, including when a modification would trigger a "policy review", and when it would be addressed under "Self Governance" arrangements;
- chapter 4 sets out how the new "Major Policy Review" process could work;
- chapter 5 sets out how the new "Self Governance" process could work; and
- chapter 6 contains our initial impact assessment of the proposed package of reforms and how it compares with the status quo arrangements.

1.14. In addition, in Appendix 2 to this document we show the results of a "back-casting exercise" to illustrate how some of the modification proposals raised in the last two years might have been dealt with under the proposed new governance arrangements.

## 2. Key issues and objectives

This chapter sets out the rationale for the reform of the industry codes governance arrangements and describes the high level framework for reform. We also assess the case for reform against the objectives of the Review.

### Question box

**Question 1:** Do you agree with our assessment of the deficiencies of the codes governance arrangements and do you agree that there is a case for reform? Are the proposed reforms a proportionate response to the problems with the status quo that we have identified?

**Question 2:** Would the Major Policy Review process enable key strategic issues (e.g. electricity cash-out or transmission access reform) to be progressed more effectively and efficiently with consequent consumer benefits?

**Question 3:** Would a Self Governance route be suitable for a significant proportion of modification proposals?

**Question 4:** If both the Major Policy Review and Self Governance routes were implemented, is there a case for retaining an Improved Status Quo path?

**Question 5:** If this package of reforms is implemented, should it apply to all codes? If not all, which? Should the introduction be phased?

### Introduction

2.1. Since their introduction, the industry code arrangements have worked well to deliver incremental reforms. However, with the increasing emphasis on sustainable development, the nature of participation in the electricity and gas sectors is changing with the entry of smaller renewable participants and smaller suppliers. In addition, the nature of the regulatory issues facing industry participants, Government and Ofgem is becoming more challenging in the face of climate change and, from a security of supply perspective, Great Britain's increasing dependence on external energy sources.

2.2. Recently, the code governance arrangements have been severely tested in two key strategic reform areas that are significantly impacted by public policy issues including sustainable development and security of supply. These reform areas are electricity transmission access and electricity cash out reform. In both these key strategic areas, progress under the codes arrangements has been made difficult or delayed. We consider that delays and difficulties in the delivery of strategic reform also means that the benefits to consumers of reforms are not delivered or are delayed. The delays and difficulties that have been experienced have been caused by a variety of factors including:

- multiple proposals being raised on key policy issues;
- duplication of assessment processes, with assessments being performed by Ofgem, code panels and industry participants;
- 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.

2.3. We consider that 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 or progressed more slowly. This is particularly the case where proposals are developed in a piecemeal fashion, since each major modification takes around 200 days for a code panel to process<sup>6</sup>

2.4. Ofgem recognises that it is important that parties with divergent views should have the opportunity to express these and input into reform debates. It is also important that all parties' views are properly considered by decision makers such as Ofgem. However, it should not be a pre-requisite of reforms that all parties agree by consensus on the need for reform or the nature of the reforms that should be progressed. Further, provided all parties are consulted and robust analysis is undertaken on the case for reform, progress on reform should not be unnecessarily held up by divergences in views.

2.5. We have also been concerned that the current codes arrangements are complicated and make it difficult for new entrants and small players to engage in and influence major and strategic policy debates. These players often do not have the resources to match those of the larger incumbent energy companies in participating in key policy debates.

2.6. The changing regulatory and market landscape suggests that there are also likely to be other important strategic code reform challenges in the future. We therefore believe that it is necessary to consider major reforms to the code governance arrangements to ensure that strategic reforms can be considered and progressed in a holistic and comprehensive manner.

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<sup>6</sup> In the case of Grid Code amendments, the typical time taken to process a proposal is even longer at 270 days.

2.7. In the light of these challenges, we also consider that there is merit in ensuring that Ofgem's resources are focussed on codes issues that impact on competition and consumers. At present, Ofgem deals with a large number of modification proposals that have minimal impact on consumers and competition. There is also potentially unnecessary duplication of work by both the industry and Ofgem in assessing proposals of this nature.

2.8. Whilst many of these are housekeeping modification proposals, there are also a significant number of other proposals that introduce systems and process changes as well as minor governance changes that could be managed by industry without the need for Ofgem involvement. Indeed, as we have set out below, we consider that approximately 50% of the modifications decided upon last year by Ofgem could have been managed by industry participants without Ofgem involvement.

### Summary of Ofgem's proposals

2.9. The proposals set out in the following section are intended to address the issues described above by adding two new mechanisms for processing code modifications.

2.10. As we outlined in our June document, we are proposing that significant reforms requiring changes to the industry codes could in future be developed through a new "**Major Policy Review process**". This process is described in more detail in Chapter 4.

2.11. The process would be led by Ofgem, and could be initiated either when Ofgem identifies a significant policy issue or when a code modification, raised in the usual way, gives rise to significant policy issues. The conclusions of the review could take the form of detailed policy principles and directions to industry/code panels to raise modification proposals. Alternatively as we set out further below, Ofgem could itself prepare the code modification necessary to implement the conclusions of the Major Policy Review.

2.12. This process is intended to address the deficiencies in the ability of the existing code arrangements to deliver major policy reforms. In addition, a Major Policy Review process should also bring efficiency benefits by reducing the potential for Ofgem and industry resources to be taken up with multiple piecemeal modification proposals on significant policy issues. It should also enable parties to engage with a single process covering all aspects of a significant policy change including code, licence and charging methodology changes.

2.13. The introduction of a single process for considering these issues should also reduce the extent of any duplication in the analysis that might otherwise have to be undertaken by Ofgem and industry participants through the normal modification process.

2.14. We are also proposing that code modification proposals that meet defined suitability criteria could be dealt with through a new "**Self Governance process**".

We consider that the introduction of a Self Governance process represents an important improvement which would help to reduce the role of Ofgem in modifications which have minimal impacts on consumers and/or competition or Ofgem's other statutory duties<sup>7</sup>. We consider that this could increase the efficiency of the modification process with consequential better regulation benefits.

2.15. In setting out the Self Governance process, we recognise that should it be introduced it would only apply to modifications that have minimal impacts on competition and/or consumers. However, depending on the success of the arrangements it may be the case that, in the future, the scope of any Self Governance framework could be broadened. This will however depend on the protections incorporated within the Self Governance framework for small market participants and consumers and the extent to which the Self Governance process delivers robust processes and reliable analysis and decision making on modification proposals.

### Outline of the proposed package of reforms

2.16. A high level outline of a possible framework for reform is set out in Figure 1. It should be noted that there are some key variations that could be made to the framework set out below, particularly to the Major Policy Review process. These variations are considered later in this document.

2.17. The outline in Figure 1 sets out three processes for modifications to the industry codes:

2.18. **Path 1 – Ofgem led Major Policy Reviews.** These can be initiated independently by Ofgem or they could be triggered by the raising of a modification proposal on a major policy issue. This process is discussed further in Chapter 4.

2.19. **Path 2 – Improved status quo.** This process represents the current modification process under which industry and code panels assess a modification proposal before it is submitted to Ofgem for decision. However the modification process would be improved as Ofgem would make decisions only on modification proposals that are likely to have, amongst other things, impacts on competition and/or consumers. In our consultation on code administrators, we also put forward various options that might further improve the status quo approach.

2.20. **Path 3 - Self Governance.** Under this path, industry would manage the assessment process as well as the decision making on a code modification. There

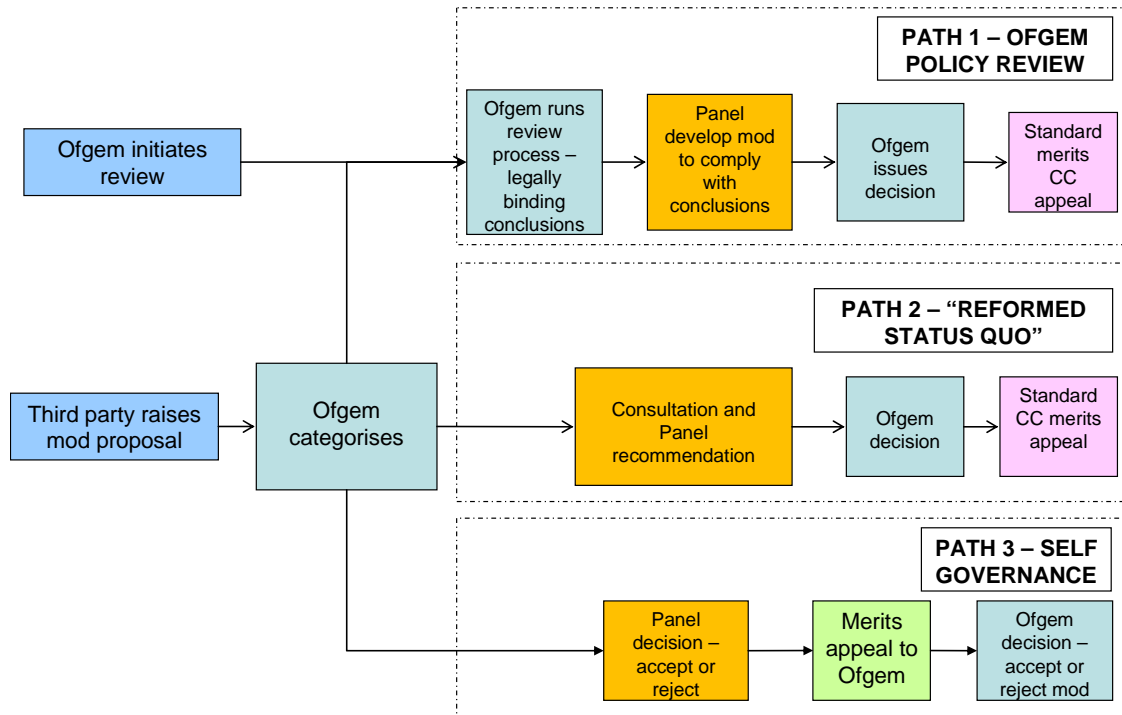
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<sup>7</sup> For the avoidance of doubt, further references in this document to consumers and/or competition in the context of the Path 2 filtering process, should be read as to also include references to Ofgem's other statutory duties.



would be a right of appeal to Ofgem if certain key criteria are met. This process is discussed further in Chapter 5.

**Figure 1: Proposed new framework**



2.21. In order to determine which Path a modification should follow, a **filtering process** would need to be introduced. Under this process, Ofgem (and potentially industry participants) would have a role in determining (either through an approval or veto process) which Path the modification should follow. The filtering process is discussed in more detail in Chapter 3.

2.22. In summary, both Paths 1 and 3 are entirely **new processes**, whereas Path 2 represents a variation to the status quo arrangements for assessing modifications. In particular, as a result of the filtering process we would expect fewer modifications to follow the Path 2 route. This is because modifications that are less material to consumer interests or competition would follow the Path 3 Self Governance route instead.

2.23. It is important to emphasise that we consider an improved version of the status quo arrangements (Path 2) would continue to play an important role if this reform package were implemented. It is also important that **appropriate safeguards and appeal mechanisms** for code signatories and other affected parties are built into the process under all Paths. Safeguards and appeal mechanisms are discussed further in subsequent chapters.

2.24. We also consider that, if implemented, the new processes should apply to **all of the codes**. Applying the new processes to all codes should enable industry participants to obtain the full benefits of Self Governance. However, we are interested in respondents' views as to whether it should alternatively apply to a subset (for example, the BSC, the CUSC, and the UNC). A potential downside to applying the new processes only to the major codes (BSC, CUSC and UNC) is that modification decisions under these codes are more likely to have consumer and competition impacts. Whilst a proportion of these modifications could be subject to self governance we consider that this proportion may be lower for the three major codes relative to the other codes.

### The industry codes governance review objectives

2.25. Our fundamental objective is to develop an overall set of code governance arrangements that deliver benefits to consumers and industry participants on key strategic policy issues and which lead to more effective and efficient decision-making. In practical terms, this means a better use of Ofgem and industry resources in code decision making, and ensuring that Ofgem resources are focussed on those issues that are likely to impact on competition and/or consumers.

2.26. The package of reforms is also intended to meet the objectives for good governance laid out in the November 2007 letter and reiterated in the June document ('the Review Objectives'). These objectives are:

- 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.

2.27. In Chapter 6 we have set out our initial draft impact assessment of the proposals, which includes an evaluation of our reform proposals against the Review Objectives.

### 3. Filtering criteria

This chapter describes the proposed filtering process for allocating modification proposals.

#### Question box

**Question 1:** Once a modification has been raised, should the filtering decision be taken by Ofgem (with a panel recommendation) or by the relevant panel with an Ofgem veto?

**Question 2:** What criteria should be applied to assessing whether a modification falls into Path 1 or Path 2?

**Question 3:** How should we treat modifications that fall within the scope of an existing Major Policy Review?

#### Description of filtering process

3.1. If the package of reforms outlined in Chapter 2 were implemented, then a new step is required in the modification assessment process. Specifically, a process would need to be developed to decide which of the three Paths a modification assessment should follow. This process would be known as the “filtering process” and it is the subject of this chapter.

3.2. We propose that the filtering process would first involve applying a set of criteria to identify whether the modification proposal would fall within a Path 1 Major Policy Review. For any modification proposals that do not fall within a Path 1 Major Policy Review process, a second set of criteria would be applied to determine whether the proposal should follow a Path 2 route. If the modification did not meet the Path 2 criteria it would default to the Path 3 Self Governance route.

3.3. It should also be noted that a Major Policy Review process does not need to be initiated by a modification proposal and could be initiated where Ofgem identifies a key deficiency in the codes arrangements or where, for example, the code arrangements are likely to be impacted by government led public policy initiatives.

3.4. In designing a filtering process, two key issues arise:

- How are the filtering decisions taken?
- What criteria are applied?

## Options for the filtering process

3.5. In this section we set out two options for designing the filtering process.

### ***Option A – Ofgem allocates modifications***

3.6. Under this approach, once a code modification is raised, it would need to be submitted to Ofgem. As a first step Ofgem would consider whether the modification met the criteria for Path 1. If not, it would consider whether the criteria for Path 2 had been met. Modifications which do not satisfy either set of criteria would default to self governance arrangements.

3.7. A possible variation on this approach is to enable the relevant code panel to meet to consider the modification proposal and to make a recommendation to Ofgem on which path the modification should take. Ofgem would then reach its decision having taken the panel recommendation into account.

3.8. Another variation may be for the criteria to be applied to Path 1 and 3, with proposals which do not satisfy either set of criteria defaulting to the Path 2 enhanced version of the current arrangements.

3.9. We do not propose that Ofgem would consult on its filtering decision (nor that the decision would be appealable<sup>8</sup>), since both Paths 1 and 2 involve extensive consultation and appeal rights. However, Ofgem would give full reasons for its decision, against the criteria set out below. The filtering decision would thus be similar in some respects to Ofgem's decisions on whether to grant urgency status to a modification proposal.

### ***Option B – Industry allocates modifications with Ofgem veto over decision***

3.10. Under option B, the relevant industry panel would decide whether the modification would follow Path 2 or Path 3, subject to an Ofgem veto. Under this approach, Ofgem would have the right to veto the industry decision at any point during the industry's assessment process. For example, in the case of proposals being considered under Path 3, the Ofgem veto would allow us to "call back" assessments to the Path 2 process if it became clear during the assessment that the content of the modification was not suitable for the Self Governance process. We consider such flexibility is important, although we recognise that it might also introduce some uncertainty for industry. To the extent that we wished to "call back" a modification into Path 2 we would seek to do this as soon as possible, should we

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<sup>8</sup> Although we would note that any Ofgem decision against the filtering criteria would be subject to judicial review.

become concerned that the proposal was not suitable for the Self Governance process.

3.11. It is important to note that, under this option, industry would not be asked to consider whether a modification should be made subject to a Path 1 Major Policy Review. The industry panel's considerations would be limited to whether the proposal should follow Path 2 or 3. It would remain open however for Ofgem to indicate that the proposal should be considered within a Major Policy Review.

**3.12. We are interested in respondents' views on which of options A and B should be chosen or whether there are possible alternative approaches.**

## Filtering Criteria

3.13. In this section we set out possible filtering criteria for a Path 1 process and possible filtering criteria for Path 2.

### *Path 1- Filtering criteria*

3.14. We set out below a number of criteria which, if met, could result in Ofgem sending a modification proposal to Path 1 (major policy review).<sup>9</sup> A modification could be sent to Path 1 if it satisfies at least one of these criteria. It should be noted, as discussed later in Chapter 4, that a Major Policy Review could also be set in train by Ofgem itself, without a triggering modification.

3.15. The proposed Path 1 criteria are set out below:

1. **Ofgem considers that the proposal is likely to have significant impacts on competition or gas and electricity consumers.** This view may only be based on a qualitative assessment since the idea is to streamline the mod process and not to add another stage to it.
2. **Ofgem considers that the proposal is likely to create significant cross-code or code-licence issues.** Paths 2 and 3 may be inappropriate when a modification raises an issue that could require changes to more than one code, licences or to charging arrangements.
3. **Ofgem considers that the proposal is likely to have significant impacts on the environment, sustainable development or security of supply.** If Ofgem considers that the ultimate decision on a modification should significantly engage Ofgem's wider statutory duties (e.g. environment, sustainable development<sup>10</sup>, and security of supply), it may send the modification to Path 1.

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<sup>9</sup> Ofgem would have the right but not the obligation to instigate a Major Policy Review.

<sup>10</sup> We would note that Ofgem has issued guidance (in June 2008) relating to the treatment of

### ***Path 2 – Filtering criteria***

3.16. We set out below a number of criteria that would be applied to determine whether a modification is sent to Path 2. If a modification does not meet these criteria it would be sent to Path 3. A modification could be sent to Path 2 if it satisfies any one or more of these criteria. The criteria below are similar to criteria that are applied under DCUSA to assess whether modifications should follow a Self Governance route:

- 1. The modification is likely to have impacts on consumers;**
- 2. The modification is likely to have impacts on competition;**
- 3. The modification is likely to discriminate in its effects between classes of users;**
- 4. The modification is directly related to safety or security of supply or relates to the management of market or network emergencies; or,**
- 5. The modification impacts on the code change process or proposed other material code governance changes.**

3.17. We think that it would be possible for a modification proposal to be sent to Path 3, but for an alternative proposal to be raised during the course of the assessment that, if it had been proposed originally, would have triggered Path 2. As a result, we propose that the Path 2 filter should be re-applied to alternative proposals. We also consider that ideally all related modifications should be treated under the same path to ensure that they are treated consistently and through the same process.

### **Modifications falling within the scope of an existing Major Policy Review**

3.18. It may be the case that a modification that is raised falls within the scope of an existing Major Policy Review that has already been initiated by Ofgem.

3.19. Our proposed approach for these circumstances is that there would be a **moratorium** on raising code modifications on issues that are the subject of Path 1 Major Policy Reviews. Under such an approach, the Authority would be able to designate a modification that has been raised as falling within the scope of a Path 1 review. The modification would then be formally rejected although, where

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greenhouse gas emissions (GHG emissions) under the existing code objectives and has indicated that it is now possible for industry and relevant code panels to take into account the economic costs of GHG emissions in the same way that Ofgem, industry and code panels would consider other economic costs and benefits when considering a modification against the relevant code objective governing efficient and economic network operation. Whilst this is the case it is possible for a modification to raise significant environmental issues which may justify the initiation of the Path 1 process.

appropriate, the ideas within the proposal would be absorbed into the Major Policy Review process. This approach would give a clear signal to market participants that modifications on Major Policy Review areas should not be raised during the course of a Major Policy Review.

3.20. To the extent that a proposed modification fell outside the scope of a Major Policy Review (or does not trigger a Major Policy Review) the modification would be considered under Path 2 or 3.

### **Back-casting exercise**

3.21. In order to inform consideration of these proposals, we have undertaken a review of all of the modification proposals that have been raised over the past 12 months to assess how often each Path might have been used had they been available. This assessment, known as the “back-casting” exercise, is described in Appendix 2.

3.22. Based on this analysis and our own current experience in the codes area, we consider that a Major Policy Review might be triggered on average once or twice per year, and that modifications not dealt with through Path 1 (the large majority) might be split roughly equally between Paths 2 and 3.

3.23. Reform of electricity cash-out and electricity transmission access reform (currently being addressed through the Transmission Access Review process) are two examples of the kinds of policy area which we envisage would trigger the Path 1 process.

3.24. Experience with existing Self Governance arrangements suggests that, once industry participants become familiar with the arrangements and panels are confident in operating the rules, Self Governance could be used for an increasing number of modification proposals.<sup>11</sup>

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<sup>11</sup> We would note however that this would be likely to require a change to the criteria that we have proposed in this document for Path 2 proposals.

## 4. Proposed “Major Policy review” process

### Chapter Summary

This chapter focuses on the process for undertaking Major Policy Reviews, what form the outcome of the review would take, and what safeguards would be built in. Our view is that the process should be flexible in terms of length, as long as there is an appropriate degree of consultation.

### Question box

**Question 1:** What process should be adopted for Major Policy Reviews?

**Question 2:** What are your views on the Options for determining the outcome of a Major Policy Review?

**Question 3:** How ought the outcomes of a Major Policy Review to be implemented?

**Question 4:** What safeguards and appeal mechanisms should be in place?

**Question 5:** Should there be a moratorium on subsequent code modifications following the completion of a Major Policy Review?

## Major Policy Reviews

4.1. The introduction of a Major Policy Review process would involve a fundamental change in the way in which code modifications on key strategic issues are managed, with Ofgem taking on a greater role in the development of modifications and the delivery of reform in key strategic areas.

4.2. In this chapter we consider how the process would operate under 5 key headings:

- The process for undertaking a Major Policy Review
- The outcomes of a Major Policy Review Process
- The process for implementing Ofgem’s conclusions
- Appeal and safeguard mechanisms
- Moratoriums on subsequent code modifications



## Process for Major Policy Reviews

### *How can a Major Policy Review be initiated?*

4.3. We consider that a Major Policy Review could be initiated in two circumstances. Firstly, Ofgem could identify a major deficiency within an industry code and elect to commence a review. Ofgem might also commence a major policy review as a result of Government led public policy initiatives. Secondly, as we set out in Chapter 3, a Major Policy Review could also be triggered by an industry participant raising a code modification proposal within a key strategic area.

4.4. We note that in the case of a Major Policy Review that has been triggered by a code modification (rather than on Ofgem's own initiative), the triggering modification would not form directly part of the review process. Instead, we propose that it would be formally rejected at the start of the Major Policy Review process, although the ideas contained within the proposal would, to the extent appropriate, be considered as part of the Major Policy Review process and, if appropriate, could form the basis for drafting implementing modifications at the conclusion of the review.

### *How often would we expect to initiate Major Policy Reviews?*

4.5. It will be important to ensure that Major Policy Reviews are undertaken on a proportionate basis. We consider that Major Policy Reviews should only be used in limited circumstances where there are significant policy issues present and, as set out in Chapter 3, based on our current experience and knowledge we would not intend to initiate more than 1 or 2 such reviews a year.

### *Will licence amendments be required?*

4.6. We envisage that amendments to licences will be required to recognise formally when a Major Policy Review has been triggered. This change is important as it will ensure that the outcomes of the process (considered further below) become binding. As such, the licences would need to create an over-arching framework under which a review would occur with the possible result that industry/code panels would be required to raise a modification proposal to address the concerns identified by the review.

### *A "one size fits all" approach to Major Policy Reviews?*

4.7. However, we do not believe that there needs to be a specific "one size fits all" process for establishing how a Major Policy Review should be conducted. We consider that imposing a "one size fits all" process around a Major Policy Review is likely to be inflexible as the level of consultation undertaken within a Major Policy Review could potentially differ depending on the nature of the issues under consideration. For example, a Major Policy Review on an issue such as electricity transmission access might require multiple consultations, and industry workshops. By contrast, a Major Policy Review on an issue such as trade and transfer of gas

entry capacity rights might require fewer consultations. Ultimately therefore the structure of the process and the appropriate amount of consultation should be proportionate to the subject and scope of the review.

#### *The role of code panels*

4.8. It should also be noted that under each of the options outlined below in this Chapter, the relevant code panels will have a role in developing and/or evaluating the code modification proposals that arise from the Major Policy Review process.

### **Outcome of Policy Reviews**

4.9. In order to be effective the outcome of the policy review must make clear what changes are needed to industry codes (and possibly to other documents). In the section below we set out three options for determining the outcome of a Major Policy Review.

#### ***Option 1 - High level binding conclusions***

4.10. Under this approach Ofgem would carry out the review and develop high level policy conclusions. Ofgem would issue a binding direction to code panels/relevant licence holders to raise a modification proposal(s) that would deliver the conclusions of the review.

#### ***Option 2 – Detailed binding conclusions***

4.11. Under this approach, Ofgem carries out the review and develops detailed conclusions which could take the form of a binding outline of a code modification proposal. This option would involve Ofgem defining the parameters of any new arrangements in much more detail than Option 1. Under this approach, the code panel/relevant licence holder(s) would be required to develop a modification proposal based on the binding outline.

#### ***Option 3 - Ofgem prepares modification proposal and legal text***

4.12. Under this approach Ofgem would carry out the review and draft the modification proposal(s) necessary to implement the conclusions, including legal text.

#### ***Discussion of options***

4.13. We note that Option 3 would give the greatest certainty that the conclusions of the policy review would be effectively implemented. It is also likely to ensure that the reform process is speedier relative to Options 1 and 2 which would require the industry and code panels to develop modifications that meet Ofgem's binding

conclusions. In particular, it would remove the risk that industry participants could raise multiple modification proposals following the completion of the Major Policy Review process, which would in turn take up significant resources and could undermine the original purpose of the Major Policy Review process.

4.14. There is also the possibility under Options 1 and 2 that the modifications raised by industry/code panels would not adequately reflect Ofgem's policy conclusions. To deal with this situation, it might be appropriate for Ofgem to have a backstop power either to require the code panel to raise a more suitable modification, to 'step in' and progress a modification or to raise a modification itself i.e. default to Option 3. We would welcome views on whether such a power would be proportionate or desirable.

4.15. Option 3 would also involve Ofgem in the detailed drafting of legal text. This may not be a good use of Ofgem resources, and may not be the best way of making use of industry expertise. By contrast, Options 1 and 2 would facilitate industry engagement in developing the detail of the modifications and industry would bring their commercial expertise to shaping the detail of the modifications. This may in turn facilitate innovative thinking by industry participants if they are able to own the modifications themselves. It should be noted that under Option 3 Ofgem would consult on the development and preparation of the code modification and, as such, industry participants would be able to contribute to its development through such a consultation process.

4.16. It is possible that under all of the options Ofgem may be perceived to be lacking independence in its decision making on the modification proposal if it has also influenced the development of the proposal or, in the case of Option 3, prepared the modification proposal itself. Whilst under each of these options Ofgem would play an important role in influencing the ultimate policy outcome, this would be undertaken through a process of consultation and with the protection of an appeals mechanism.

4.17. We also note that each of these options is not necessarily mutually exclusive. There may for example be benefits in providing Ofgem with the flexibility to adopt either an Option 1, 2 or 3 approach depending on the nature of the issue being considered.

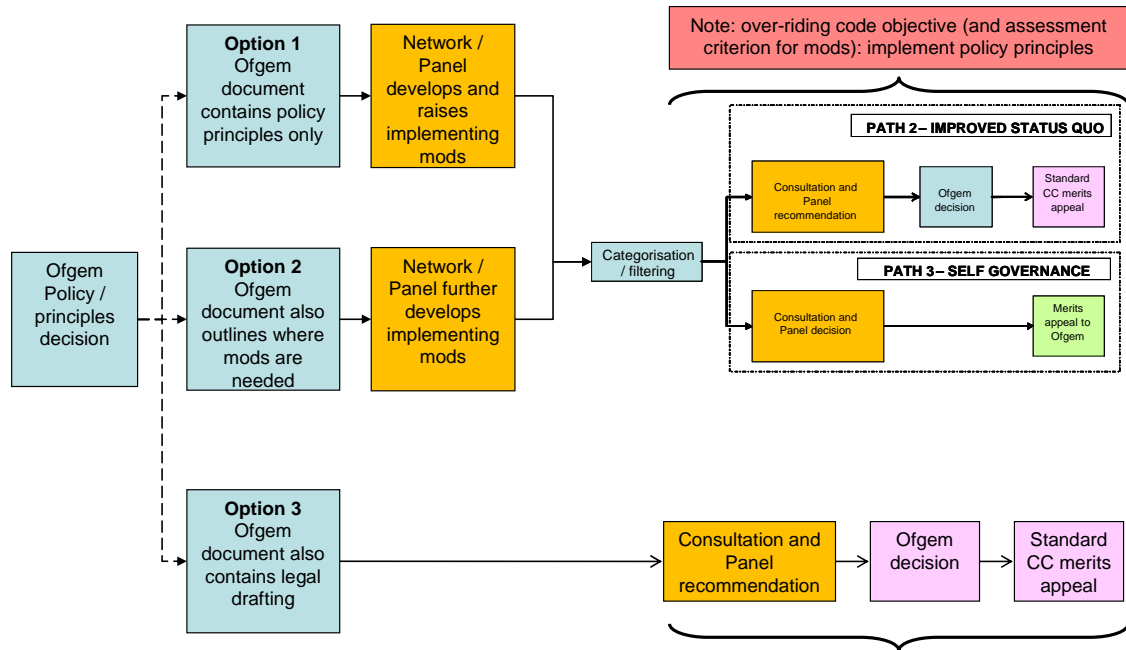
4.18. We are interested to hear respondents' views on each of these options.

## **Implementing the outcome of Policy Reviews**

4.19. The process for implementing the outcome of the policy review will depend on the option chosen for the format of the conclusions of the review process discussed in the preceding section. In Figure 2 below we illustrate the possibilities. Under options 1 and 2, the policy conclusions would be passed to industry to develop detailed modification proposals. A possible outcome under this approach could be that the modification proposals would then be assessed under either Path 2 or Path 3 in the normal way. Under option 3 the outcome would be an already worked-up modification proposal(s), including legal drafting. This would be (formally) raised by

the industry without further change, and passed to the relevant code Panel for assessment.

**Figure 2: Implementing the outcome of the policy reviews**



4.20. In order to implement Options 1 and 2, a licence obligation could be introduced requiring the relevant network licence holder to comply with a direction from the Authority arising out of a Major Policy Review. This could take the form of a direction to the licence holder to raise a modification proposal(s). Alternatively, the Major Policy Review process could be reflected in the code objectives with a code objective established governing the “implementation and efficient discharge of Authority directions arising from a Major Policy Review”. Arguably, an Authority direction under the licence could already be reflected in some of the existing code objectives, which for many codes includes “the efficient discharge by the licensee of the obligations imposed on it by the licence”.

4.21. Our initial view is that the relevant network operator should have an obligation to raise modifications necessary to implement the outcomes of a policy review. This obligation (which would be generic in form rather than focussed on specific policy areas) could be introduced through a licence modification. Our initial view is that this would be sufficient and would not require any changes to the code objectives.

**4.22. Under Options 1 and 2 the relevant licence holder would raise the code modification proposal and it would follow the normal code modification process, with the relevant code panel issuing its recommendations on the proposal. As discussed above, we would welcome views on whether Ofgem should have backstop powers to reject the modification and introduce one itself if the original modification failed to reflect Ofgem’s policy conclusions.**

4.23. Under Option 3, Ofgem would be vested with the power to raise the code modification. The relevant code panel would then consult on the proposal and make a recommendation. The Authority would then make its decision on the modification proposal.

4.24. We would welcome respondents' views on the process for implementing the conclusions of the Major Policy Review.

### **Appeal Mechanisms**

4.25. Under all Options 1, 2 and 3 described above for implementing the outcomes of a policy review there is the possibility of an appeal to the Competition Commission under the existing Energy Act 2004<sup>12</sup> framework following the Authority's decision on the modification proposal. Such an appeal would be available once the Authority had reached its final decision and only in circumstances where that decision was against the recommendation of the relevant code panel.

4.26. As the existing statutory framework provides for an appeal (in the circumstances outlined above) we do not consider that there need to be any additional appeal rights. We also recognise that industry participants would additionally have the ability to apply to judicially review any decision made by Ofgem following a Major Policy Review.

4.27. We consider that the creation of additional appeal rights to the Competition Commission, for example at the end of the Major Policy Review process, would arguably be disproportionate when an effective appeal right already exists. In addition, the creation of additional appeal rights would require changes to legislation under the Energy Act, which could only be made by the Secretary of State.

4.28. We would welcome respondents' views on appeal rights.

### **Moratorium on subsequent modification proposals**

4.29. We wish to consider whether, in order to maximise the efficiency benefits of the Path 1 process, Ofgem should have the option of postponing consideration of a modification proposal if it relates to issues that have been considered recently (say, within two years) in a Major Policy Review. Alternatively a complete moratorium could be placed on any code modification proposals being raised following the completion of a Major Policy Review, where the modification proposals address issues that were covered in the review.

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<sup>12</sup> The Electricity and Gas Appeals (Designation and Exclusion) Order 2005: <http://www.opsi.gov.uk/si/si2005/20051646.htm>.

4.30. A moratorium of this nature might have the benefit of preventing the re-opening of issues that have just been decided upon and might promote certainty. A significant downside however is that a moratorium may unnecessarily prevent incremental improvements being made to a recently introduced framework. Experience suggests that when significant reforms are introduced in a particular policy area, there are inevitably some problems and issues arising which might need to be addressed.

4.31. An alternative approach is to allow modifications to be raised following the completion of a Major Policy Review but only at the discretion of Ofgem or subject to an Ofgem veto. Ofgem would then be able to permit a modification to proceed provided it was not seeking to re-open the issues addressed in the Major Policy Review.

4.32. We would welcome views from respondents on this issue.

## 5. Proposed "Self Governance" process

This chapter discusses the proposed Self Governance process and consults on a range of issues including decision making and appeal rights.

### Question box

**Question 1:** If current Panel / voting arrangements for any code are to be changed, which model is optimal (Independent Panel, Representative Panel, signatory voting)?

**Question 2:** Should it be mandatory for panels to have a consumer and a small market participant representative?

**Question 3:** What voting procedures should apply governing code decisions?

**Question 4:** What appeal mechanisms should be in place? Should defined appeal arrangements be set out or should Ofgem have discretion over whether or not to hear an appeal?

**Question 5:** Should a consumer and small participant representative have an automatic right of appeal?

### Self Governance process

5.1. The final key element of the proposed Major Policy Reform and Self Governance framework is the nature of the Self Governance process that should apply once a modification proposal is allocated to Path 3. A key concern in designing Self Governance processes is to ensure that they conform to the objectives of the Review and in particular that there are safeguards in place, particularly for small market participants and consumer representatives.

5.2. We recognise that there are likely to be alternative ways to introduce Self Governance, and we would expect industry code signatories to take a leading role in developing their own procedures, subject to certain safeguards being present.

5.3. In developing suitable Self Governance arrangements, it is important to recognise that each of the codes has evolved differently with different panel structures and decision making arrangements. Whilst there may be benefits in seeking to harmonise these arrangements, we do not consider that harmonisation is a necessary pre-requisite to establishing Self Governance.

5.4. The design of the Self Governance process needs to address four main questions which we discuss in the following sub-sections. These questions are:

- Who should be the decision maker for the modification proposal?
- What voting procedures should apply governing decisions?
- Should there be mechanisms to send proposals back to Path 2?
- What appeal rights should exist?

### Who makes the decision on the code modification?

5.5. In this section we discuss three potential options for defining the decision maker under a Self Governance framework.

- **Independent panel approach.** One option is to have an independent code panel vote on code modifications sent to the Self Governance route. In this context, “independent” means that members of the panel would be obliged to reflect a personal view when voting, rather than the view of their employer or sector of the industry. An independent panel might nevertheless be elected on the basis of stakeholder groupings (i.e., each stakeholder group could elect a certain number of Panel members). This option reflects the current BSC arrangements.
- **Representative panel approach.** A second possibility would be for the decision to be taken by a representative code panel. In this case, stakeholder groupings would elect panel members who would then be explicitly required to represent the views of that stakeholder grouping when voting. This option reflects current UNC arrangements.
- **Voting by code signatories.** A third option would be for the decision to be taken by a vote of all code signatories. This would reflect current DCUSA / SPAA arrangements.

5.6. Each of the three methods has advantages and disadvantages.

5.7. An independent Panel should in theory lead to more principle-based decisions, and should make it more likely that decisions properly reflect the code objectives in cases where the commercial interests of Panel members’ employers are engaged. Conversely, it may be difficult in practice to ensure that panels are and are seen to be independent, especially once the panel’s role moves from being advisory to decision-making.

5.8. A representative panel would allow commercial tensions (which may be proper considerations for the subset of modifications submitted to Self Governance) to be discussed openly. Having a representative panel voting, rather than all signatories, may also be more efficient. For example, it is arguably disproportionate to have signatories vote on housekeeping modifications. A possible disadvantage with



representative panels is that this might make their capture by the larger commercial interests, including the big 6 energy suppliers, more likely.

5.9. With either representative or independent panels the constitution of the panel, as well as the identity of the individuals chosen, may have a big impact on decisions.

5.10. A mix of representative panel and signatory voting would be another possibility. For example, there could be a right of initial appeal against panel decisions resulting in a signatory vote, such that any party wishing to challenge the outcome could put the issue to a more general signatory vote. This would reflect the current SPAA arrangements.

5.11. Voting by signatories directly is clearly more open, but may be inefficient or disproportionate. Signatory voting might also make it more difficult for smaller parties and new entrants to make their voices heard.

5.12. A key issue for Ofgem under any Self Governance based decision making structure will be **to ensure that the interests of small market participants and consumers are protected**. Our initial view is that under any Self Governance framework it will be important for there to be a consumer representative and a small participant representative on any panel (whether independent or representative).

5.13. A further important question is whether the same decision making process should be used for Paths 2 and 3. In principle, the only difference between the two paths is that under Path 2 the outcome is a recommendation to Ofgem, whereas in Path 3 the outcome is a decision. On the one hand, it might seem overly complex to have different rules for voting (and certainly overly complex to have differently constituted Panels) according to whether a modification proposal is following Path 2 or Path 3. On the other hand, the advantages and disadvantages of, for example, representative and independent panels may be different if the task of the panel is decision-making rather than advisory. For example, code signatories may be less willing to submit to the decisions of an independent Panel than a representative one.

5.14. We would welcome respondents' views on decision making structure under a Self Governance framework.

## Form of voting

5.15. In this document we consider two potential models that could be adopted for voting arrangements. The choice of model may depend in part on whether an independent or representative panel is deciding on the modification proposal.

5.16. For either kind of panel (or for signatory voting), decisions could be taken by simple majority or super-majority of votes cast. As with existing Self Governance arrangements, a further option would be for votes to be weighted by some metric of size e.g. customer numbers.

5.17. Under a super-majority model if the panel is representative, or for signatory voting, the decision could require agreement among either all or a majority of the constituencies (for example, more than 50% of Transporter votes and more than 50% of Shipper votes). The current SPAA and UNC arrangements are examples of this type of arrangement. One potential problem with requiring agreement from all constituencies is that one constituency might support one modification proposal, and another an alternative, with the result that no change is implemented, even if all groups see merit in reform. This pattern of behaviour already occurs under the existing code arrangements, where panels are often split and no recommendation is made to the Authority.

5.18. There are several trade-offs under the super majority models outlined above. The higher the threshold is for reaching agreement, the harder it would be to make progress through the Self Governance route. Conversely however, higher thresholds may also provide protection against poor decisions and there is less likely to be an appeal at the end of the process. If it is easier to take decisions, then more is achieved in terms of code change but there is a bigger risk of deficient outcomes, and potentially a higher likelihood of appeals and Ofgem intervention. There is probably a similar trade-off between simple majorities and ones requiring majorities of each constituency.

5.19. For signatory voting it might also be necessary to specify rules on minimum number of votes (or mandatory voting). Without such a rule, decisions could be made by a small number of industry participants. However, it could also be argued that this does not matter if there is an appeals process, and that it should be for the industry to make the Self Governance process work. Mandatory voting (or removing the right to appeal for parties that did not vote) would also be a problem for small parties that are resource-constrained.

5.20. We invite views from respondents on appropriate voting models.

## **Mechanisms to send modifications back to Path 2**

5.21. The principle behind the Self Governance process is that, at least initially, it should only be used for modification proposals which have apparently little impact on consumers or competition. We consider that under any Self Governance process there is a risk that consumer or competition issues might become apparent later on in discussions on modifications that are following the Path 3 route. It is therefore important to consider whether a mechanism should be introduced to enable modifications to be sent back to Path 2.

5.22. In Chapter 3, we discussed the concept of Ofgem having a veto, at any stage in the process, over a filtering decision undertaken by a code panel. Clearly, with a veto approach, Ofgem could at any time re-direct a modification into Path 2 from Path 3. However in the absence of an explicit veto of this nature, and in circumstances where Ofgem is required to take a filtering decision once the modification is raised, it is necessary to consider whether a formal mechanism should be established to enable a modification to be re-directed into Path 2.

5.23. We consider that there are three potential options:

- Ofgem could decide at any point before a decision is made to accept or reject the proposal that the modification should revert to Path 2; and/or
- Any party with concerns regarding the impact of the proposal on consumers or competition could request that Ofgem take the proposal into Path 2 with the decision on whether to do so left to Ofgem. This might be a disproportionate route, particularly if an appeal is open to any party at the end of the Self Governance process; and/or
- A nominated consumer (e.g. Consumer Focus) or small participant representative could request that the proposal be re-directed to Path 2 so that Ofgem acts as the decision maker on the proposal.

5.24. Which option, or combination of options, is appropriate might depend on the nature of the appeal rights available to parties at the end of the appeal process. For example, if consumers or small market participants have appeal rights, it may be disproportionate for them also to have rights to request that Ofgem re-direct a modification into Path 2.

5.25. We would welcome the views of interested parties on re-direction mechanisms and the options outlined above.

## Appeals process

5.26. Our view is that an appeals process is an essential protection that must be part of the Self Governance process where industry takes decisions on code modification proposals. This is particularly the case in view of the concerns we have already expressed in the context of the governance review regarding the impact of the code arrangements on small market participants and consumers (or their representatives) and the difficulties that they often face in engaging in codes processes. It may therefore be important for small market participants and consumers to have a right of appeal. In this section we discuss appeal processes and thresholds for allowing an appeal to be heard.

5.27. As with voting arrangements, there is a balance to be struck between the risks of making it too difficult to appeal a decision made under the Self Governance arrangements<sup>13</sup> and making it so easy to appeal that the Self Governance arrangements are undermined.

5.28. As discussed above, the nature of any appeal process might also depend in part on the voting structures adopted for decisions on code modifications. If the thresholds for approving a modification are set very high (e.g. 65% of votes from each voting constituency, as used in the SPAA) then there may be less need for appeals to Ofgem on the basis that a significant cross section of the industry supports a proposal. In such instances the trigger threshold for an industry participant to lodge an appeal might be high (e.g. x% of a constituency). Conversely, if the thresholds are lower there might be bigger risks of deficient decisions or costly outcomes and a greater case for an appeal right.

5.29. Ultimately, until such time as voting structures for Self Governance are resolved it will be difficult to determine the exact nature of an appropriate appeal structure. *We also expect industry participants to take a leading role in defining an appropriate appeal structure.* For the purposes of consultation however, Ofgem has suggested four high level options:

- **X% of a constituency.** One option might be to require at least a minimum amount of support for an appeal - for example, at least a certain percentage of signatories, or at least a certain percentage of at least one constituency. A risk with this option is that it would probably not sit well with initial signatory voting, since it would effectively reset the threshold for agreement.
- **Pre-notification of concerns.** A second option might be to require the appellant to have raised its concerns during the process or to demonstrate that the Panel's treatment of its concerns had been deficient. This option would, however, not provide a right of appeal to small users that had been unable to participate in the process earlier due, for example, to resource constraints. This option might also leave the threshold for appeals too low.
- **Disproportionate impact.** A third option would be to specify the grounds of appeal in terms of the decision having a disproportionate impact on a particular class of signatories. The latter is similar to the existing arrangements in codes that have Self Governance processes.
- **Ofgem discretion on whether to hear appeal.** Under this option there would be a general right of appeal on process or substance issues with Ofgem having discretion as to whether to allow the appeal to be heard. This option would avoid

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<sup>13</sup> A deficient decision could be one that does not follow due process or fails to properly consider the proposal against the relevant code objectives.

having to specify detailed rules of appeal and is potentially more flexible. However, it may also increase the likelihood of appeal and increase costs to Ofgem and ultimately industry participants.

*Minimum automatic rights of appeal for consumers and small market participants?*

5.30. We consider that providing consumers (e.g. Consumer Focus) and small market participants with a general right of appeal is an important and minimum safeguard, particularly if there are concerns that the 6 large energy suppliers might dominate the Self Governance process. Our initial view is that there should be automatic rights of appeal for Consumer Focus and/or small participant representatives over industry decisions on Self Governance modifications. Such appeal rights could be embedded within the code modification rules for the relevant code. However, we also consider that if an appeal is lodged and is unsuccessful then the party raising the appeal should bear the costs.

*The nature of the appeal body*

5.31. Whilst Ofgem is a natural candidate for the management of an appeal process, consideration should also be given to whether an independent arbitrator should be appointed to hear the appeal. In particular, if appeals are likely to relate to commercial issues with little impact on competition or consumers then it may be possible for an independent arbitrator to hear the appeal.

*A right of appeal beyond Ofgem?*

5.32. A further issue is whether or not there should be a right of appeal beyond Ofgem (e.g. to the Competition Commission). Our view is that to have two levels of appeal for the kinds of decision that will go the Self Governance route would be disproportionate. Our view is that the only situation in which a serious issue could arise that could not appropriately be addressed through an appeal to Ofgem might be a case in which a party felt that the modification proposal should not have been dealt with through Self Governance in the first place. However, this particular concern could be mitigated with mechanisms (already discussed above) that enable modifications to be re-directed to Path 2.

*Raising further modification proposals*

5.33. Finally, in respect of appeals it is important to be aware that a code signatory that is not happy with the outcome of the Self Governance process would have the opportunity to raise its own modification (which might not be assessed through Self Governance). This route might perhaps be appropriate for a situation in which a number of modifications had resulted in a cumulative adverse impact on a class of parties.

## 6. Impact assessment

**In this chapter we set out an initial impact assessment on the package of reforms including Major Policy Reviews and the introduction of Self Governance.**

### Question box

**Question 1:** Do you agree with our assessment of the package of reforms against the Review Objectives?

**Question 2:** Do you agree with our quantitative assessment of the potential cost savings of reform?

**Question 3:** Do you agree with our assessments of the potential impact of reform on consumers, competition and sustainable development?

**Question 4:** Do you agree with our assessment of the potential unintended risks and consequences?

### Background

6.1. This chapter sets out our initial Impact Assessment (IA) of the package of reforms described at a high level in Chapter 2.

6.2. In setting out this IA we evaluate the case for reform against the objectives of the Codes Governance Review, before proceeding to consider other impacts.

### Key issues

6.3. In Chapter 2 we identified a number of key issues with the existing codes governance framework. Without repeating these issues here, they are summarised as follows:

6.4. **Inability to progress major policy reforms.** In its June document the Authority indicated that the current arrangements do not facilitate the delivery of major policy reforms in key strategic areas. In some cases reforms are not delivered and in other cases they may be delayed. We consider that such a failure means that the benefits to consumers of reforms are not delivered or are delayed. The Authority noted that electricity cash out reform and electricity transmission access reform were examples of the failure of the codes arrangements to deliver change in key strategic areas.

6.5. **Inefficient decision making processes.** In its June document, the Authority noted that the current arrangements are inefficient in that the Authority is involved

in decision-making on matters that have little or no impact on consumers and/or competition, and Ofgem's analysis often duplicates work done by the industry.

**6.6. Complexity and barriers to entry for smaller players and new entrants.**

In its June document, the Authority noted that the current arrangements are complicated and make it difficult for new entrants and small players to engage in and influence major policy debates.

## The package of reforms

6.7. A high level description of the package of reforms is set out in detail in Chapter 2. In summary we are proposing that significant reforms requiring changes to the industry codes could in future be developed through a new "**Major Policy Review process**". This process is described in more detail in Chapter 4.

6.8. The process would be led by Ofgem, and could be initiated either when Ofgem identifies a significant policy issue or when a code modification, raised in the usual way, gives rise to significant policy issues. As we noted in our June document the conclusions of the review could take the form of detailed policy principles and a direction on code panels/relevant licence holders to raise modification proposal(s).

6.9. We are also proposing that code modification proposals with minimal impacts on consumers and competition and which meet defined suitability criteria could be dealt with through a **new Self Governance process**. This process is described in more detail in Chapter 5.

## Assessment of reforms against the Review Objectives

6.10. In this section we assess the package of reforms set out in Chapter 2 above against the Review Objectives. In setting out this assessment it is important to note that we are evaluating the package of reforms against the present status quo. We consider that the introduction of Major Policy Reviews and Self Governance processes should provide the following benefits when assessed against the Review Objectives:

- **Cost effectiveness and efficient change management.** The Major Policy Review processes would enable major policy issues to be addressed in a joined up fashion, with improved quality of analysis, as opposed to piecemeal analysis of issues that form the subject of individual modification proposals. It should also allow all relevant issues to be brought within the scope of the review, for example, irrespective of which code might have to be modified in order to address the issue. In summary, we expect the Major Policy Review process to:

- reduce the need for multiple piecemeal code modifications and therefore multiple assessment processes undertaken by industry, code administrators and code panels;

- o reduce the potential for multiple impact assessments undertaken by Ofgem in the event that piecemeal code modifications are raised over different time periods<sup>14</sup>;
- o reduce the extent to which analysis is duplicated between Ofgem and industry participants on key code modifications. This is because the analysis would be undertaken by Ofgem as part of the Major Policy Review process; and
- o make it more likely that an optimal outcome for consumers would be achieved.

6.11. In addition, the introduction of Self Governance processes should also provide for cost savings and efficiencies in the change process by reducing the role of Ofgem in modifications with minimal implications for consumers or competition. It should also ensure that Ofgem resources are focussed on issues that bring value for money to consumers. In addition, by taking an additional step out of the decision making process, it is possible that Self Governance modifications may be implemented on a faster timeline.

6.12. We have also set out below a qualitative analysis of the cost savings and efficiency benefits that could be provided through the introduction of Major Policy Reviews and Self Governance.

- **Proportionality.** We consider that the introduction of Self Governance processes should help to ensure that Ofgem's involvement in code modifications is proportionate to the issues being raised. In particular, Ofgem would step away from modifications that have minimal consumer or competition impacts. We consider that this would be consistent with our better regulation duties.

In addition, as we have already noted in Chapter 4, we envisage that Major Policy Reviews would be conducted on a limited basis, with potentially 1 or 2 Major Policy Reviews per year.

- **Inclusivity, accessibility, transparency and effective consultation.** We consider Major Policy Reviews should help to ensure that all stakeholder views are taken into account through an open and transparent consultation process in which all parties, including smaller participants and consumers should be able to participate effectively. As we have noted above, we consider that the existing code modification

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<sup>14</sup> It should be noted that it is possible that Ofgem will still need to undertake impact assessments on Path 2 modifications which it considers are important but which do not form the subject of a Major Policy Review. As such, there remains a risk that both industry and Ofgem will have to undertake analysis under the Path 2 process.



arrangements are complex and that small participants and consumers find it difficult to engage in code change processes. We consider that Major Policy Review processes should help to alleviate these concerns and facilitate better engagement by providing a single process (as opposed to multiple modification processes) to engage and participate in.

We also consider that the process of filtering modification proposals should provide some transparency benefits by providing information to industry participants on those modifications that have impacts on consumers or competition. This in turn may assist industry participants in identifying which modification work-groups they might wish to participate in and which modifications they might wish to respond to.

- **Rigorous and high quality analysis.** We consider that Major Policy Reviews should improve the analysis undertaken on key strategic policy issues. This is because the Major Policy Review process would provide a holistic approach to considering all the relevant commercial and public policy issues, thereby avoiding piecemeal analysis that often arises when these issues are addressed through multiple modifications raised across different time periods.
- **Flexible change processes.** We consider that the introduction of Major Policy Reviews and Self Governance should provide for more flexible change processes and ensure that Ofgem and industry resources are focussed on those issues that have impacts on consumers and/or competition.
- **Independent and objective processes.** We consider that Major Policy Reviews should help to ensure that key strategic policy reforms are managed and progressed via an independent and objective basis without being dominated or excessively influenced by the views of particular industry participants, particularly the larger incumbent energy companies who have the resources and a better ability to influence outcomes than smaller participants.

6.13. We would welcome views from industry participants on our assessment of Major Policy Reviews and Self Governance against the objectives of the Review.

## Quantitative evaluation of cost savings

6.14. In addition to the qualitative assessment of the package of reforms set out in this chapter, we have also carried out a provisional quantitative assessment of the impact of these proposals on the ability of the code governance arrangements to deliver more efficient change processes.

6.15. In terms of Self Governance, we expect the cost of assessing the Path 3 modifications to be lower because there will no longer be the dual assessments by both industry and the Authority inherent in the status quo. In terms of Major Policy Reviews, we expect the process to deliver better policy outcomes more quickly, efficiently and effectively than the current arrangements. We therefore consider that the Path 1 process should deliver cost savings in a range of circumstances, including

for example where there are major public policy issues and/or significant cross code issues.

6.16. As we have noted above, we also consider that the Major Policy Review process should ensure that the benefits to consumers of major policy reforms in key strategic areas such as electricity cash out or electricity transmission access are not delayed or hindered. The impact of improved governance processes on the delivery of reforms in key policy areas is difficult to quantify and is dependent on the area of reform under consideration. For the purposes of this initial IA, however, we have undertaken a case study on electricity cash out reform to illustrate some of the benefits and savings that the Major Policy Review process could provide. This is set out below.

### ***Electricity Cash-out reform case-study***

6.17. In this section we assess the impact of the Major Policy Review proposals on costs by reference to past electricity cash-out reform modifications which, in our view, might have been considered within a Major Policy Review framework had it existed at the time. We examine both the indirect benefits (to consumers) and the direct savings that might have been achievable.

6.18. The electricity cash-out arrangements are a fundamental part of the regulatory design of the electricity industry trading arrangements, and are the mechanism through which market participants are commercially incentivised to balance the electricity they bring onto the system through generation or purchases with that which they take off through consumption and sales. The arrangements underpin competition in the wholesale electricity sector as well as the efficient operation of the electricity system, and provide incentives on parties to ensure that they have sufficient contracted generation to meet customer demand. The cash-out arrangements are thus extremely important to ensure that there is sufficient generation capacity in the market and therefore security of supply.

6.19. The detailed rules for electricity cash-out sit in the BSC, and it has proved extremely difficult to achieve co-ordinated and efficient policy development in this area. A number of code modification proposals related to electricity cash-out were reviewed as case studies in the Brattle critique of the industry code governance arrangements we published in June 2008,<sup>15</sup> and illustrate some of the problems the present Major Policy Review proposals are designed to address.

### ***Background – electricity cash out modifications under the BSC***

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<sup>15</sup> *Critique of the Industry Codes Governance Arrangements, a report for Ofgem*, Brattle, June 2008 – see pages 31-35.

6.20. Ofgem has been looking at electricity cash-out reform since at least August 2003, when modifications P136 and P137 (marginal cash-out) were raised. In March 2004 Ofgem set up an informal review process ("the cash-out review") to take forward a review of the electricity cash-out arrangements in a co-ordinated and comprehensive fashion. The cash-out review process included both Ofgem consultation documents and twelve industry working group meetings were held during 2004 and 2005. In August 2005 NGC raised a further cash-out modification (P194). In late 2006 there were further modifications (P201, P202, P205), following which P205 was ultimately accepted.

6.21. In 2007, Ofgem initiated a further electricity cash-out review, and three modifications were raised (P211, P212, P217). Both P211 and P212 were raised close together although P217 followed a number of months later. The modifications set out mutually incompatible proposals, with the result that Ofgem had to delay its consideration of P211 until P217 had proceeded through the modification process. A further consequence of the separate timing of the modifications was that Ofgem needed to undertake 2 separate impact assessments, namely an impact assessment on P211 and P212 and an assessment on P217 which was raised later in the process. Whilst Ofgem issued decisions on the last of these proposals in October 2008, there are likely to be further piecemeal reform proposals that will be raised over the coming year.

6.22. In addition to the modifications, two Issues Groups were established during the course of the cash-out review. The objectives of these groups were to consider solutions for a range of issues that had been raised during the cash-out review but were not covered by the proposed modifications. Thus far, no specific proposals have emerged from these groups. In part this reflects lack of industry consensus and divergent commercial views, but some participants have also commented that some of the more fundamental reforms being considered could not be implemented through the existing BSC governance process.

6.23. In summary, electricity cash-out has been under continuous review over at least the last five years and it is not clear that all potential improvements to the current arrangements have yet been properly considered. While this process has dealt with a number of issues that could be considered separate aspects of the cash-out arrangements (the first set of modifications addressed a move to marginal cash-out, while the more recent ones addressed "tagging out" of system balancing actions), many of the issues are inherently inter-related and it would have been more efficient if a set of coherent policy principles had been developed first and then given effect to by a single package of modifications. Indeed, the introduction of a Major Policy Review process, could be expected to lead to a small number of implementing modifications rather than the larger number of mutually-incompatible competing alternatives that we have seen under the current arrangements.

#### *Quantification of cost savings under Major Policy Review process*

6.24. We cannot, of course, be certain how electricity cash-out reform would have evolved had the Major Policy Review process been available at the time. However, we can make an initial attempt to assess the cost savings that might be achieved.

6.25. In our view, a Major Policy Review process might have taken around 18 months to address an issue with the underlying analytical complexity of electricity cash-out. This estimate allows for six months to analyse the scope of the review and set out detailed analytical requirements, six months to conduct the analysis (with support from relevant industry parties), and six months to work up policy conclusions. A further six months might have been required to process and evaluate the resulting implementing modifications.

6.26. This period (totalling around 24 months) is approximately half the overall time taken to achieve the reforms that have been implemented to this date. In addition it is also important to note that reform of the electricity cash-out arrangements may continue with further modifications being raised therefore further extending the time advantage associated with the Major Policy Review route.

6.27. We consider there would have been benefits to consumers from having more efficient electricity cash-out arrangements in place several years sooner. The most commonly discussed and recognised deficiency in the electricity cash-out arrangements has been the pollution of cash-out prices by costs of resolving network constraints, particularly since the start of BETTA. Ofgem's IA for P217 suggested that the effect of constraint pollution under BETTA has been to increase cash-out prices by £37m per year or approximately £100m since the start of BETTA. It seems reasonable to assume that these costs might have been avoided if a Major Policy Review had resulted in a modification like P217 being implemented in 2005.

6.28. As regards direct savings, under the Major Policy Review process we assume there would have been a maximum of 3–4 worked up implementing modifications, rather than the 9 that were actually put forward. We consider this to be a cautious assumption. It is quite possible that only 1 worked up modification would have been necessary. On this basis, we would expect the new arrangements to absorb no more than half of the combined resources of Ofgem and the industry that were in fact used up.

6.29. In our view, any quantification of this impact in financial terms is necessarily speculative. Nevertheless, some indicative figures may be useful to gauge the importance of these proposals.

6.30. The cost to Elexon of analysing BSC cash-out modifications is perhaps £100k per modification. As such Elexon might have saved around £500k from the number of modifications being reduced from 9 to 4. The Elexon cost per modification has been arrived at by halving the cost reported by Elexon to Brattle as part of its critique of the governance arrangements for the most expensive modification that it has dealt with so far (P98). In addition, the costs incurred by NGET in providing analysis relating to the likely impact of the various modifications would have been reduced. Whilst we have no data from which to estimate NGET's savings, we assume that these could have been as high as £100k.

6.31. The cost to Ofgem of dealing with electricity cash-out related issues over the past five years has been broadly equal to 1-2 FTEs or £150-200k per year (including

consultant spend). If these resources had only been required for thirty months instead of five years, Ofgem might have saved £375-500k.

6.32. The cost to industry of engaging with the process may have been around £2m in total. The cost per company of engaging with BSC was reported as around £250k/yr.<sup>16</sup> If electricity cash-out were around 20% of this during the years when electricity cash-out modifications were being put forward, and there are roughly 8 companies significantly engaged, the cost would have been about £400k/yr. Consequently, the total cost over 5 years would be around £2m. Again, halving the period taken to conclude the electricity cash-out debate might have saved industry around £1m.

6.33. This analysis suggests total direct cost savings of nearly £2m.

### **Cost savings achieved through Self Governance**

6.34. We have already set out some of the qualitative efficiency benefits of introducing Self Governance. In this section we set out some analysis of how these benefits can be quantified.

6.35. The back-casting exercise described in Appendix 2 suggests that roughly half of all modifications might be suitable for the Self Governance route.

6.36. We think that it is reasonable to suggest that Ofgem would save at least half of the resource it currently devotes to these modifications. Ofgem currently incurs approximately £1m per year in staff and consultancy costs related to modifications (including both staff directly responsible for modifications and staff in other divisions that provide significant policy input). We estimate that although "Self Governance" modifications are roughly half of all modifications by number, they might take only one quarter of the total Ofgem resource. We therefore estimate that the Self Governance proposals might save of the order of £125k per year of Ofgem costs.

### **Impact on Consumers**

6.37. We consider that the package of reforms including Self Governance and Major Policy Reviews should provide significant benefits to consumers. We illustrated this above in our case study on electricity cash-out reform.

6.38. We consider that Major Policy Reviews should help to ensure that policy reforms within key strategic areas are progressed in a timely manner so that

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<sup>16</sup> *Critique of the Industry Codes Governance Arrangements, A report for Ofgem*, Brattle, June 2008

consumers can obtain the benefits of these policy reforms earlier than might otherwise be the case. We would also expect consumers to benefit from the efficiency and cost savings associated with Major Policy Reviews that we have already identified above to the extent that these savings are passed through to consumers by suppliers.

6.39. We also consider that improvements in the governance processes that help facilitate engagement from consumer representatives should also help to promote better policy making and the development of policy proposals that enhance competition. As we have already noted, the piecemeal, complex and resource intensive nature of managing key policy reforms under the existing code arrangements makes it difficult for small market participants and consumers to engage in these process. We expect that the introduction of a more holistic Ofgem led policy making process, through Major Policy Reviews, should help facilitate engagement from consumers and hence improve policy making with benefits to competition.

### **Impact on Competition**

6.40. To the extent that the future Major Policy Reviews improve policy outcomes and help to ensure the timely delivery of reform in key policy areas, this should be beneficial for competition and the overall functioning of the gas and electricity markets.

6.41. We also consider that the improvements in the governance process that help facilitate engagement from consumers (as set out above) should equally help small market participants to engage in reform in key policy areas, with consequential benefits to policy making and potentially benefits to competition.

### **Impact on Sustainable Development**

6.42. It is important to note that many of the smaller participants who struggle to engage in existing codes processes, due to their complexity and resource intensive and piecemeal nature, are smaller generators, often from the renewable sector (including distributed generation). This has been particularly the case with the Transmission Access Review process where smaller generators have found it difficult to engage in the code modification and policy development process.

6.43. We consider that the introduction of Major Policy Review processes should help to facilitate engagement in the reform processes from parties such as this. In particular the introduction of a single holistic process for considering all key policy issues in a particular policy area should help facilitate engagement from these parties. Enabling smaller renewable players to engage better in the codes process may therefore provide consequential benefits in terms of policy development in the sustainable development area although it is difficult to estimate the extent of these benefits.

## Impact on Health and Safety

6.44. We do not think the proposals would have any implications for health and safety.

## Risks and Unintended Consequences

6.45. In this section we discuss the potential risks and unintended consequences associated with the Self Governance and the Major Policy Review processes.

### *Self Governance risks*

6.46. In respect of the Self Governance process we have identified two possible risks. First, if relatively few modifications are sent to Path 3 or if the majority of the Path 3 decisions are appealed to Ofgem, the proposals will not have made a significant difference to the cost of assessing modifications (relative to the status quo arrangements). Second, there is a risk that the Self Governance framework is used inappropriately for modifications that have significant impacts on customers, competition, or Ofgem's wider duties, which are not taken into account through the Self Governance process.

6.47. Our view is that the first of these risks is small but realistic and will need to be carefully managed (for example, through the design of the filtering and appeal process) to ensure that decisions with minimal implications for consumers and/or competition are progressed through Path 3.

6.48. Equally, we think that the risk of inappropriate decisions being taken through Self Governance is a real one, but that it can be properly managed through a combination of Ofgem's role in the filtering process, an effective appeals mechanism and having the ability for Path 3 modifications to be diverted into Path 2.

### *Major Policy Review risks*

6.49. In respect of the Major Policy Review process, the major risk is simply that the new process will not be effective as anticipated. Our expectation is that the new process will be a much more effective way of arriving at a coherent and well-thought through policy position that can be implemented across the relevant industry codes and other industry documents in a timely manner, avoiding the problems that have been identified with the status quo arrangements.

6.50. If our expectation is not borne out, the risk is that the new process results in policy principles which are not efficiently and effectively implemented through code modification proposals.

6.51. This risk could be triggered where:

- Under Options 1 and 2 (for the Major Policy Review process, as set out in Chapter 4) industry participants use the modification process to undermine the outcomes of the Major Policy Review. This risk would be mitigated if Ofgem had backstop powers to raise its own modification(s) if those put forward are unsatisfactory.
- Under Options 1 and 2 (for the Major Policy Review process, as set out in Chapter 4) the conclusions of the Major Policy Review are not expressed with sufficient certainty and clarity for industry participants to understand how they could best be implemented through code modifications). If Options 1 or 2 are adopted it will therefore be important for Ofgem to seek to mitigate this risk by expressing the outcomes of the review clearly and in a form that can be easily translated into code modification proposals. It will also be important for Ofgem to work with industry under Options 1 and 2 to address any concerns around clarity.

### **Post implementation review**

6.52. In our view, if our proposals are implemented, it will be important to review the effectiveness of the new arrangements to ensure that they are working well. We therefore propose to undertake a review after three years of operating the new arrangements, should they be implemented. The review will, at high level, compare the new regime with the status quo, and will also examine in detail at least one instance of the operation of the new processes. We expect that the outcome of the review would include simple statistics such as the number of modifications processed via the new routes, and an in-depth analysis of how the policy review process has compared with the expectations set out in Ofgem's final IA on these proposals.



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## Appendices

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## Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.2. Responses should be received by Friday 27 February 2009 and should be sent to:

- Mark Feather
- Director, Industry Codes & Licensing
- 3<sup>rd</sup> Floor, Ofgem, 9 Millbank, London, SW1P 3GE
- 020 7901 7437
- mark.feather@ofgem.gov.uk

1.3. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.4. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.5. Any questions on this document should, in the first instance, be directed to:

- Mark Feather
- Director, Industry Codes & Licensing
- 3<sup>rd</sup> Floor, Ofgem, 9 Millbank, London, SW1P 3GE
- 020 7901 7437
- Mark.feather@ofgem.gov.uk

### **CHAPTER: One**

No questions.

### **CHAPTER: Two**

**Question 1:** Do you agree with our assessment of the deficiencies of the codes governance arrangements and do you agree that there is a case for reform? Are the

proposed reforms a proportionate response to the problems with the status quo that we have identified?

**Question 2:** Would the Major Policy Review process enable key strategic issues (e.g. electricity cash-out or transmission access reform) to be progressed more effectively and efficiently with consequent consumer benefits?

**Question 3:** Would a Self Governance route be suitable for a significant proportion of modification proposals?

**Question 4:** If both the Major Policy Review and Self Governance routes were implemented, is there a case for retaining an Improved Status Quo path?

**Question 5:** If this package of reforms is implemented, should it apply to all codes? If not all, which? Should the introduction be phased?

### **CHAPTER: Three**

**Question 1:** Once a modification has been raised, should the filtering decision be taken by Ofgem (with a panel recommendation) or by the relevant panel with an Ofgem veto?

**Question 2:** What criteria should be applied to assessing whether a modification falls into Path 1 or Path 2?

**Question 3:** How should we treat modifications that fall within the scope of an existing Major Policy Review?

### **CHAPTER: Four**

**Question 1:** What process should be adopted for Major Policy Reviews?

**Question 2:** What are your views on the Options for determining the outcome of a Major Policy Review?

**Question 3:** How ought the outcomes of a Major Policy Review to be implemented?

**Question 4:** What safeguards and appeal mechanisms should be in place?

**Question 5:** Should there be a moratorium on subsequent code modifications following the completion of a Major Policy Review?

**CHAPTER: Five**

**Question 1:** If current Panel / voting arrangements for any code are to be changed, which model is optimal (Independent Panel, Representative Panel, signatory voting)?

**Question 2:** Should it be mandatory for panels to have a consumer and a small market participant representative?

**Question 3:** What voting procedures should apply governing code decisions?

**Question 4:** What appeal mechanisms should be in place? Should defined appeal arrangements be set out or should Ofgem have discretion over whether or not to hear an appeal?

**Question 5:** Should a consumer and small participant representative have an automatic right of appeal?

**CHAPTER: Six**

**Question 1:** Do you agree with our assessment of the package of reforms against the Review Objectives?

**Question 2:** Do you agree with our quantitative assessment of the potential cost savings of reform?

**Question 3:** Do you agree with our assessments of the potential impact of reform on consumers, competition and sustainable development?

**Question 4:** Do you agree with our assessment of the potential unintended risks and consequences?

## Appendix 2 – Back-casting exercise

1.1. We sought to categorise every modification on which we had made a decision in the 12 months leading up to (and including) 16 October 2008 by the path that we thought they would follow under the proposed model. We did not include modifications that are already subject to Self Governance (for example, modifications to part 2 of the DCUSA).

1.2. The exercise covered 122 decisions relating to the following codes: BSC; CUSC; UNC; Grid Code; STC; SPAA; MRA; Distribution Code; DCUSA; and IGT UNC.

1.3. We concluded that modifications relating to the following topics would have been likely to follow Path 1 under the proposed model:

- Electricity cash-out review (one modification, BSC P212)
- Electricity Transmission Access Reform (two modifications, CUSC CAP 131 & 150)

1.4. All the remaining modifications either fell in to Path 2 or 3.

1.5. The overall results were:

Path	Number of modifications	% of total modifications
Path 1 Ofgem policy review	3	2.5%
Path 2 Business as usual	57	47.0%
Path 3 Self-governance	62	50.5%
Total	122	100%

## 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, the Energy Act 2004 and the Energy Act 2008, 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.<sup>17</sup>

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 accordingly<sup>18</sup>.

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 inter-connectors.

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 them<sup>19</sup>; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>20</sup>

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<sup>17</sup> entitled "Gas Supply" and "Electricity Supply" respectively.

<sup>18</sup> 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.

<sup>19</sup> 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.

<sup>20</sup> The Authority may have regard to other descriptions of consumers.

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:

- Promote efficiency and economy on the part of those licensed<sup>21</sup> 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;
- To 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 Regulation<sup>22</sup> 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.

1.9. The Energy Act 2008 contains provisions which, once commenced, will modify the general duties of the Authority in carrying out its functions under the Gas Act and the Electricity Act. In particular, those changes will mean that, when carrying out its functions in the manner which it considers is best calculated to further its principal objective, the Authority must do so by having regard to the need to contribute to the achievement of sustainable development equally with the need to have regard to the need to secure that all reasonable demands for electricity and gas are met and that licensees are able to finance their regulated activities.

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<sup>21</sup> or persons authorised by exemptions to carry on any activity.

<sup>22</sup> Council Regulation (EC) 1/2003

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1.10. It has also been highlighted within the text of the principal objective that the Authority's consideration of the interests of consumers includes both future as well as existing consumers.

1.11. The Energy Act 2008 received Royal Assent on 26 November 2008 but these provisions do not have legal force until they are commenced. We do not yet have a commencement date for the new provisions but it is likely to be early in 2009.

1.12. During the period between the Energy Act 2008 having received Royal Assent and commencement of the provisions which affect its duties, the Authority must continue to apply the principal objective and its statutory duties in accordance with the Gas Act and the Electricity Act as they currently stand (i.e. prior to the Energy Act 2008 amendments taking effect), although it will be mindful of the changes that are forthcoming. The Authority already takes account of sustainable development in its decisions but with the change in duties the weight that is attached to such considerations will be increased.



## 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:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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