

By email: Mark.feather@ofgem.gov.uk

Dear Mark,

CODE GOVERNANCE REVIEW

This response is provided from the perspective of someone actively involved in current industry code governance structures.

I also work closely with a range of smaller participants, especially in my role as convenor of the Energy Supply Forum. This is an industry body with no formal status but which acts as a focal point for discussions by independent energy suppliers. This response is not provided on their behalf but I believe many of the points below to varying degree are supported by many parties with whom I deal. You would need to discuss these points directly with them but many are very resource constrained, and they do not ordinarily engage in regulatory consultations unless their cash flows are directly impacted or at risk.

The key challenge of the code governance review is to build on the strengths of current governance structures (transparency, regulatory determination, independence of objectives and analysis), while tackling the visible weaknesses in the current system (fragmentation, incumbent dominance of modification groups, variable analysis and outputs).

Major policy review

I strongly support the principles behind the code governance review and inherent in the four Ofgem code governance review consultations to date. The proposals taken as a package constitute good progress in addressing the challenge provided they are translated into tangible actions and important details are clarified. More specifically:

- There is a pressing need for a major policy review (MPR) mechanism, especially given the fragmentation of current code governance structures.

To work this will need a merits based appeal mechanism, which avoids current Competition Commission practice based on litigation processes. This process must be much more accessible (i.e. low cost) to smaller participants.

That said developmental streams within the industry need to be constructed so that the MPR is the exception and not the rule, and the process is invoked where industry forums do not deliver. The failure to address how governance codes can better tackle strategic issues is the biggest gap in the proposals produced to date.

More generally Ofgem should not have to initiate an MPR to make its policy preferences known. The outcome of an MPR should be a mandate to the industry to develop detailed proposals with defined outcomes—Ofgem's role should not be to define detailed solutions.

Role of panels and code administrators

- The arrangements for code administrators could be significantly rationalised, with best practice identified and clearer guidance developed through a code of practice applied to code administrators on the approach to assessing modifications and writing up reports.

The code administrators should be resourced to act as the “critical friend” to those impacted stakeholders not directly represented in the central processes. This mandate should be backed up by clear, unambiguous duties.

If this approach were implemented, there would be no need to provide direct funding to wider stakeholder groups. However a consumer advocacy group such as that formed under the Australian NEM would also have merit to bring interested stakeholders together and bring greater coherence to their point of view.

The code administrators and not the modification groups should own the reports provided to the panels, which should comply with established guidance on form and content. The guidance should set out non-discretionary aspects of the assessment (similar to Ofgem’s own guidelines on its approach to impact assessments).

In turn the panels should be independent and non-representational. Their concern should be the robustness of the report and recommendations against the code objectives and guidelines. A hybrid structure (a mix of industry elected members and stakeholder nominees all acting under common relevant objectives) such as the BSC panel seems to work best

All panels should have independent chairs and views and recommendations should issue to Ofgem from the relevant panel; they should not be owned by the code administrator or owner (as is the case with CUSC).

- Network users and relevant stakeholders should be able to raise change proposals on charging methodologies in the same way as they are able under codes.

It is anomalous that market participants should be denied the right to bring forward change proposals in an area where they are most directly impacted. It may be efficient to merge charging arrangements into relevant existing codes (transmission into CUSC; distribution into DCUSA), but only provided the overarching governance arrangements are adapted to the critical friend administrator/independent panel model.

Panel guidance

- Environmental obligations in industry governance codes should be made explicit

Associated guidance should be developed for panels to provide a point of reference to code panels. This might be embodied in the code of practice referenced above.

I have developed many of these thoughts in a comment published in *Energy spectrum* (attached at A) and in a presentation at the industry workshop in February (available from the Cornwall Energy website [here](#)).

Please let me know if you would like me to expand on these views or provide anything further.

Regards,

Nigel Cornwall

A: Energy Spectrum 167 – Perspectives

Code governance review augers real change

Ofgem recently issued four important consultations arising from the review of industry codes governance. This *Energy perspective* looks at the progress of the review and concludes constructive and significant proposals are emerging.

Defining the problems

When it announced the review in November 2007 (*Energy spectrum 112, p10*), Ofgem set out in detail the developments which had prompted it. A number of important changes had occurred. It had been several years since some of the major codes, such as the BSC and CUSC were introduced, and new codes had been designated. There had been structural changes in the industry and statutory changes to the regulatory framework, including introduction of Ofgem's requirement to conduct impact assessments before reaching important decisions, implementation of its better regulation duties and the introduction of a right of appeal to the Competition Commission on certain code decisions where Ofgem and panels go different ways.

Ofgem also raised serious concerns about the quality and depth of analysis provided in some code modification reports and how arguments were substantiated. It alleged that modification documents often did not make sense on a stand-alone basis, "lacked an effective and critical assessment of modification proposals" and often did not adequately assess costs and benefits against code objectives. It expressed concern about the effectiveness of assessment and supporting working group processes, for example on changes to electricity cash-out. And it made the point that it could only meet the high standards required of it if code modification reports contained well-argued and effective analysis.

The regulator also questioned whether code objectives were still fit for purpose given changes in the statutory framework, such as its duties in relation to sustainable development. Each code has its own applicable objectives, which tend to share common themes relating to the promotion of competition and efficiency. In April 2007 Ofgem had already sent an open letter to the CUSC panel chairman, subsequently forwarded to other code panel chairs, advising that the costs of carbon emissions could be factored into an assessment of efficient and economic network operation. It highlighted the risk that different participants could have differing perceptions on what was within the scope of existing code objectives, with the result that they might not consider issues that were legitimately within their scope. It concluded that this could mean the Authority had to decide on modification proposals not properly informed by industry and code panel consideration.

Another area of concern was the governance of network charging methodologies. Currently charging methodologies used to derive network charges are governed wholly by the network operators and owners under licence. Market participants can only influence change through the consultation processes and cannot propose changes themselves. This is despite the fact that the methodologies and charges can have major impacts on participant decisions.

The regulator also listed a range of other issues including: the fragmentation of code administration and the multiplicity of code administrators; whether there was scope for more self-regulation; whether the structure of code Panels and other committees were appropriate; and the quality of legal text.

The scope of the review was informed by a comprehensive report commissioned from consultants Brattle Group and lawyers Simmons and Simmons, who were asked to prepare an independent critique of the code governance arrangements. At the end of June Ofgem published its findings on the scope (*Energy spectrum 140, p12*).

Identifying options

In its decision on the scope of the review the regulator stressed that it was seeking to build on the existing code arrangements rather than fundamentally changing the codes and did not intend to explore fundamental changes such as code mergers. But two new themes emerged. Firstly, Ofgem said it was concerned that the codes arrangements had hindered progress in key reform initiatives that could have provided important pro-competitive and customer benefits. It cited in particular the progress on cash-out reform and on transmission access. Secondly, there was the welcome recognition of the need to address the difficulties faced by smaller participants in code engagement. Ofgem acknowledged that code processes have become increasingly dominated by the Big Six who have the resources to deal with the complexity of the governance arrangements and, in turn, the ability to influence policy outcomes.

Five work-strands were established, four of which have led to consultations to date, and we look at these below¹. In the round, we think the proposals thus far demonstrate a thorough and considered approach, although at this stage there is no guarantee that some of the more radical options will translate into firm change proposals.

Work-strand 1-- Environmental duties

In November (*Energy spectrum 161, p12*) Ofgem invited views on whether it should introduce express requirements for panels to consider greenhouse gas issues, and whether they should have wider responsibilities to assess environmental impacts. The regulator had already decided in scoping the review that it would not consult on aligning all of its statutory duties or principal objectives to the objectives in the various codes. This was because it believed it was more appropriate for the Authority to consider wider public interest issues. This occurred against a background in which it had already issued in June guidance to panels that some of the economic costs of greenhouse gases could be relevant to current code objectives, and thus the matter was already covered under the existing legal framework.

But the proposal to make the requirement explicit in new licence provisions has the merit of clarity in our view. It would also help to reflect down the line to industry and code panels the changes in Authority duties introduced in the Energy Act 2008, which promoted its sustainable development duty to be on an equal footing with duties to meet reasonable demand and financing authorised activities.

We are less enthusiastic with the allied proposal to introduce wider responsibilities on panels to assess broader environmental impacts, such as

impacts on visual amenity or local air quality. It is questionable whether the panels have the expertise or whether this approach is proportionate, given that arguably these issues could be better considered under the planning framework.

Work-strand 2--Governance of charging

A consultation in September examined options for network charging methodology governance (*Energy spectrum 151, p11*). Ofgem expressed no preference for any of four alternatives it proposed. These included an option for transferring the governance to the relevant industry codes, which would enable parties to raise change proposals that would be assessed by the relevant panel and then submitted to the Authority for decision. This would introduce a right of appeal to the Competition Commission where the decision diverged from the Panel recommendation. A more sweeping option would see a new code established to manage change to charging methodologies.

Both these options would establish governance of charging methodologies independent from the network owners who currently manage the process. Many smaller participants, who may not have the resources to challenge the network operators' analysis, see merit in this. The other options suggested are to retain the status quo, or to modify the current licence regime to enable network users but also customer representatives to raise modifications. From our perspective, there is no right answer but any of the change options have merit, though merging the arrangements into the relevant codes would establish a much more appropriate and consistent governance framework.

The regulator also suggested in the charging consultation that there could be a need for measures to mitigate the risks and costs of changes, including that a large number of proposals might be raised. These possible safeguards included restricting to time-windows the periods when proposals could be considered (except in exceptional circumstances), restricting the total number of annual changes or insisting on minimum support thresholds. We do not see why charging rules should be singled out for special treatment, and there is an obvious danger that any restrictions might prevent justifiable proposals being put forward and progressed in a timely way.

Work-strand 3--Major policy reviews

Arguably the most important of all the work-strands is that on major policy reviews and self-governance (*Energy spectrum 165, p9*). Ofgem wants the proposed reforms in this area to be considered as a single package, and has opened up the possibility of major change to current governance. Under this framework modification proposals would follow one of three paths. The first path would be Ofgem-led major policy review, initiated independently by Ofgem or possibly triggered by the raising of a modification proposal on a major policy issue. How prescriptive the outcome is, with high-level policy conclusions at one extreme or detailed proposals with legal text at the other, is for consultation. With the introduction of the appeal mechanism, we think this is now the right way forward to counter the innate fragmentation under current code governance. While we have concerns over the lack of detail on the size and scope of reviews and how they would be conducted, the need for more proactive developmental work is essential if current governance

structures are to measure up to the growing demands placed on the sector by policymakers.

The second path would see a modification largely follow the current process, except that Ofgem would make decisions only where, amongst other things, it could have impacts on competition and/or consumers. Under the third “self-governance” path the industry would manage the assessment process as well as the decision-making on a code modification, but this would be aimed at more minor issues, such as housekeeping or process changes where there are minimal implications for competition or consumers. Again there is much detail to be filled in as to how this would work in practice, including the “filtering process” to determine which modification follows which path, but the concept has considerable merit and could improve the efficiency of change management.

An important theme in the work-strand is that Ofgem have stressed that the interests of small market participants and consumers needed to be better protected in this process, a theme that links in with the final consultation.

Work-strand 4--Code administrators

The fourth consultation (*Energy spectrum 166, p13*), issued alongside the third, examined the role of code administrators and proposals to help smaller participants and consumers engage better with industry codes. It has also proposed options to expand the code administrator’s role to take a more active role in processing modification proposals in order to improve the quality of analysis and of decisions.

At a lower level it has also considered how there could be more consistency in the corporate governance of the codes. In particular it examines what is the appropriate degree of independence of the code administrator from the relevant network owner, to avoid any potential conflicts of interest on the part of the code administrator, and possible mechanism to achieve this. Currently there are several different set-ups, for example close integration as with the Grid Code, but an independent company Elexon for the BSC. Although harmonisation could entail some significant changes to the governance arrangements of some codes, this would be a rational step forward, and for the interim Ofgem has made some more “light-handed” proposals, including the idea that the regulator could call in and send back modifications if it considered the process was not proceeding adequately. It also looks set to adopt our proposal for a code of practice for code administrators.

Proposals to facilitate engagement by small participants, new entrants and consumers have included some suggestions worth further consideration. Ofgem has suggested establishing an advocacy panel funded by the industry, in a scheme similar to one already in existence in Australia where this approach works well, and which would provide financial assistance to advocacy groups representing those who would not otherwise be able to engage in the industry change process, with a sub-option of administration by Consumer Focus. Another option is to incorporate an advocacy role for Ofgem’s Consumer Challenge Group, which consists of people from business and domestic consumer representative organizations, with costs funded by Ofgem. Again there are shades of grey here, but these nuances should not

obscure the fact that all improve on the current arrangements which are inherently skewed in favour of the incumbents.

Maintaining the direction

So far, so good. A feature of the governance review is that there has been no overall timetable published, although in June Ofgem said it thought that the work would progress over at least the next twelve months. Yet after a very slow start progress to date as measured by these four consultations has been considerable, and the review as a whole appears to be on track to deliver significant, much-needed change. Ofgem is to be applauded for this.

Let's hope it keeps the momentum going in the light of feedback from the major protagonists who will instinctively default to support the status quo.

¹The remaining one, the code administrators working group which is examining complexity and fragmentation, is due to issue a draft report in February.