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Our Reference:
Your Reference:

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Dear Mark,

Code Governance Review: Major Policy Reviews and Self Governance

Thank you for the opportunity to comment on the above paper.

Overall, we believe that the industry codes work well and have in the past provided an effective route for change management. However, we also recognise that there are areas that could be improved and, given the changing regulatory environment and market, it may be time to consider major reform of the code governance arrangements. Against this background, we have considered the proposals set out in Ofgem's paper and reached the following main conclusions.

Fair and Proportionate Regulatory Framework

It is with considerable regret that reform of the code governance arrangements as proposed by Ofgem would lead to the effective re-regulation of the sector in relation to major policy or strategic issues, with Ofgem taking the lead rather than industry through Major Policy Reviews (MPRs). It is vital that such a move is tempered by the introduction of two additional safeguards in order to ensure that an individual party or indeed industry as a whole is not unfairly prejudiced by the MPR process. Without these proper checks and balances in place the process would be fundamentally flawed and as such, open to challenge.

First, we strongly believe that there must be an individual, automatic right of appeal where a modification proposal is raised and approved by Ofgem as a result of a MPR, in order to preserve an appropriate balance of rights across the parties. We do not agree that such a right of appeal would be disproportionate given the proposed increased role and influence of Ofgem under a MPR process. Indeed, without an automatic right of appeal, an individual party may face undue prejudice or material hardship as a result of Ofgem's increased role with no available recourse to redress. Without such a right of appeal being introduced, we believe that it would be completely unreasonable and run against all concepts of natural justice to introduce a MPR process as proposed by Ofgem.

In our view, it would be a relatively straightforward process to amend the relevant Statutory Instrument to provide for such a right of appeal and we believe that Ofgem should work with DECC to implement such a right of appeal before the MPR changes are made to ensure that a proportionate and fair regulatory framework is maintained.

Second, it is essential that the process put in place ensures that MPRs are undertaken on a proportionate basis. While Ofgem recognise this in the paper, we believe that there should be an explicit restriction placed on the number of MPRs that Ofgem can undertake in order to provide a degree of comfort to industry that MPRs will not become unduly frequent and onerous. Notwithstanding this, we recognise that unforeseen circumstances may arise where Ofgem need to launch a MPR at relatively short notice. We therefore suggest a reasonable approach would be to set a limit of, say, one MPR in electricity and one MPR in gas in any twelve month period, with scope for one *emergency* MPR to be raised within the same twelve month period in either sector, subject to it meeting an additional test of "significant urgency". In addition, a MPR annual budget should be approved and published in advance.

This would ensure effective consultation and transparency, cost effectiveness and a proportionate regulatory burden in line with the objectives of the review. Importantly, it would also ensure that the resource burden and significant industry change was managed smoothly. All of these benefits would clearly assist new entrants and smaller market participants.

Major Policy Reviews (MPRs)

In terms of the process for and implementation of the conclusions of MPRs, a number of options put forward in the paper involve Ofgem developing some form of legally binding conclusions or directions which would then be passed to industry / the relevant network licence holder to comply with and implement via code modification proposals. We would be fundamentally opposed to this approach and would strongly object to a proposed licence obligation on the relevant network licence holder to raise code modification proposals or alternatively an amendment to the relevant code objectives in order to implement the conclusions of an Ofgem-led MPR.

Such an approach would not deliver transparent, independent or objective governance and would therefore conflict with the objectives of the review as set out by Ofgem. In addition, it could create conflicting legal rights and obligations on an individual party or industry as a whole. That is, it is unclear how a legal obligation to implement the outcome of a MPR would sit with the right to appeal the outcome of a MPR to the Competition Commission and may, in effect, remove (or diminish) this key protection in relation to the most important policy or strategic change proposals.

As a consequence, we believe that the only means of ensuring MPRs are viable, legally robust and transparent is for Ofgem to explicitly take the lead by undertaking the review with full and proper consultation, cost benefit analysis, regulatory impact assessments, etc., drafting the modification proposal(s) necessary to implement the conclusions of the MPR including the production of legal text (which must be subject to industry consultation before being finalised) and finally, raising the code modification proposal to the relevant code panel for assessment. As noted in the paper, this would require Ofgem to be vested with the power to raise code modification proposals directly to panels. For the avoidance of doubt, without this explicit transparency and legal certainty, we would consider maintaining the status quo to be the only feasible option set out in Ofgem's paper.

Self-Governance

We welcome Ofgem's proposal to introduce a self-governance process for certain modification proposals. This reflects the development of a mature competitive energy market where there is less need for direct involvement by Ofgem in such modification proposals. We believe that the filtering of modification proposals into paths two or three should be undertaken by the relevant panel with an Ofgem veto over the panel decision (i.e. Option B in the paper). In our view, this approach is key to achieving the benefits of introducing a self-governance route for modification proposals as it would allow Ofgem to step back from the minutiae of code changes (albeit with a veto to "call back" proposals) and concentrate their resources on the issues that significantly affect competition or customers.

We also welcome Ofgem's recognition that harmonisation across the codes is not a necessary pre-requisite to establishing self-governance and indeed, we consider that there are significant risks in adopting a "one size fits all" approach to the codes. As a consequence, we believe that the existing arrangements in relation to panel membership, voting procedures and thresholds under each of the industry codes are fit for purpose both currently and in the event of a self-governance process being introduced and should therefore be retained.

In addition, Ofgem's analysis shows that modifications not dealt with through the MPR route might be split roughly equally between Paths 2 and 3. As a consequence, with roughly half of modification proposals likely to be dealt with through self-governance rather than going to Ofgem for a decision, this should deliver significant cost savings to Ofgem which we would hope to see reflected in Ofgem's budget requirements going forward.

We have expanded on each of these conclusions in our answers to Ofgem's specific questions set out in the attached Appendix.

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

Yours sincerely,

Rhona McLaren
Regulation Manager

CC: Paul McIntyre, Director, Energy Security and Markets, DECC

Appendix 1: Specific Questions by Chapter

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?

We believe that in general the code governance arrangements have worked well to date. We therefore do not share all of the concerns raised by Ofgem regarding the code governance arrangements. However, we recognise that there are areas that could be improved and that a degree of reform may be appropriate. In particular, we support a move away from Ofgem's direct involvement in the minutia of industry code governance and the proposed self-governance route for some modification proposals is a welcome first step in this direction.

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?

If Ofgem is to pursue any of the options other than the status quo, it is vital that a Major Policy Review (MPR) process has the necessary checks and balances in place to ensure that no party is unfairly prejudiced by the outcome of a MPR. We discuss the appropriate checks and balanced required for a MPR under Chapter Four below.

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

Yes with potential for the scope to be expanded in the future once the processes have been fully established.

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?

Yes in the short to medium term, although we would hope an increasing number of modification proposals would move from the status quo path to the self governance path once this is proven to be effective.

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

The package of reforms should be implemented across all codes for consistency and transparency.

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?

We believe that the filtering of modification proposals into paths two or three should be undertaken by the relevant panel with an Ofgem veto over the panel decision (i.e. Option B in the paper). This would not preclude the proposer making an initial assessment of which path the proposal should take. In our view, this approach is key to achieving the benefits of

introducing a self-governance route for modification proposals as it would allow Ofgem to step back from the minutiae of code changes (albeit with a veto to "call back" proposals) and concentrate their resources on the issues that significantly affect competition or customers. In addition, an Ofgem veto at any stage in the process over a filtering decision undertaken by a code panel would remove any need for a formal mechanism to be established to enable a modification to be re-directed from path three into path two (discussed in Chapter 5).

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

We believe that the criteria should be used more as "guiding principles" rather than set in stone as there would be considerable merit in ensuring flexibility in any assessment of the Path that a modification proposal should take. In addition, we believe that a test of "significant urgency" should be added to the Path 1 (MPR) criteria to allow for 'emergency MPRs' which we discuss further under Chapter Four, Question 1 below.

In relation to the proposed Path 2 criteria, we believe that the first two criteria should be qualified as almost all modifications could be viewed as ultimately having an impact on consumers or competition although this could be minimal in effect. We would therefore suggest that the word "material" is inserted in the first two criteria before "impact".

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

While a MPR is ongoing, we believe that it would be appropriate to put in place a moratorium on raising code modifications that are within the scope of the MPR.

Chapter Four

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

It is essential that the process put in place ensures that MPRs are undertaken on a proportionate basis. While Ofgem recognise this in the paper, we believe that there should be an explicit restriction placed on the number of MPRs that Ofgem can undertake in order to provide a degree of comfort to industry that MPRs will not become unduly frequent and onerous. Notwithstanding this, we recognise that unforeseen circumstances may arise where Ofgem need to launch a MPR at relatively short notice. We therefore suggest a reasonable approach would be to set a limit of, say, one MPR in electricity and one MPR in gas in any twelve month period, with scope for one *emergency* MPR to be raised within the same twelve month period in either sector, subject to it meeting an additional test of "significant urgency". In addition, Ofgem should set out their views on what MPRs they would be undertaking in advance as part of their Corporate Strategy and Plan.

This approach would ensure effective consultation and transparency, cost effectiveness and a proportionate regulatory burden in line with the objectives of the review. Importantly, it would also ensure that the resource burden and significant industry change was managed smoothly. All of these benefits would clearly assist new entrants and smaller market participants.

We would be fundamentally opposed to licence amendments 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. We do not believe that this would deliver transparent, independent or objective governance and would therefore conflict with the objectives of the review as set by Ofgem. In addition, it could create conflicting legal rights and obligations on an individual party or industry as a whole. That is, it is unclear how a legal obligation to implement the outcome of a MPR would sit with the right to appeal the outcome of a MPR to the Competition Commission and may, in effect, remove (or diminish) this key protection in relation to the most important policy or strategic change proposals.

As a consequence, we firmly believe that the only process that will ensure that MPRs are viable, legally robust and transparent is for Ofgem to explicitly take the lead by undertaking a review, drafting the modification proposal(s) including the production of legal text (which must be subject to industry consultation before being finalised) and raising the code modification proposal to the relevant code panel for assessment. As noted in the paper, this would require Ofgem to be vested with the power to raise code modification proposals directly to panels. For the avoidance of doubt, without this explicit transparency and legal certainty, we would consider maintaining the status quo to be the only feasible option.

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

We would strongly oppose Options 1 and 2 in Ofgem's paper where Ofgem would undertake a MPR and develop high level or detailed binding conclusions which industry or the relevant network licence holder would be required (via licence obligations) to comply with and implement via code modification proposals. As a consequence, we firmly believe that the only process that will ensure that MPRs are viable, legally robust and transparent is Option 3, where Ofgem drafts the modification proposal including the legal text. Please see our answer to Question 1 above for more detail.

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

We strongly believe that the only viable, legally robust and transparent means of implementing the outcomes of a MPR would be Option 3 in Ofgem's paper, that is where Ofgem is vested with the power to raise the code modification proposals to the relevant panel for independent assessment. Please see our answer to Question 1 above for more detail.

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

If Ofgem introduce a MPR process, it is absolutely vital that the appropriate safeguards and appeal mechanisms are in place in order to ensure that no party is unfairly prejudiced by the MPR process. Therefore, the existing safeguards must be maintained including full and proper consultation, robust impact assessments with full cost benefit analysis and independent panel assessment.

In addition, we would strongly urge Ofgem to introduce two additional safeguards which we firmly believe are necessary in order to maintain the principle of natural justice within the governance arrangements and ensure proportionality is maintained. Without these additional safeguards, we believe that the process would be fundamentally flawed and as such, open to challenge.

First, we strongly believe that there must be an individual, automatic right of appeal where a modification proposal is raised and approved by Ofgem as a result of a MPR, in order to preserve an appropriate balance of rights across the parties. We do not agree that such a right

of appeal would be disproportionate given the proposed increased role and influence of Ofgem under a MPR process. Indeed, without an automatic right of appeal, an individual party may face undue prejudice or material hardship as a result of Ofgem's increased role with no available recourse to redress. Without such a right of appeal being introduced, we believe that it would be completely unreasonable and run against all concepts of natural justice to introduce a MPR process as proposed by Ofgem.

As Ofgem state, the introduction of this additional right of appeal would require a change to the "The Electricity and Gas Appeals (Designation and Exclusion) Order 2005" by the Secretary of State. However, the Statutory Instrument is subject to the negative resolution procedure which is a relatively straightforward process where the proposed changes are made available for viewing / objection over a period of 28 days before being implemented (if no objections are received). Therefore, a change to the relevant Statutory Instrument would not be subject to a debate / vote in Parliament and as such, we would urge Ofgem to work with DECC to introduce such a right of appeal to ensure a proportionate and fair regulatory framework is maintained.

On this point, there is currently no right of appeal provided for under the above Statutory Instrument in relation to the Distribution Connection and Use of System Agreement (DCUSA), as a result of DCUSA being introduced after the Statutory Instrument came into force. We would therefore propose that DCUSA is added to the list of documents contained in the Statutory Instrument in order to provide a consistent right of appeal across the industry codes.

Second, we believe that there should be an explicit restriction placed on the number of MPRs that Ofgem can undertake in order to provide a degree of comfort to industry that MPRs will not become unduly frequent or onerous. We would therefore suggest a limit of, say, one MPR in electricity and one MPR in gas in any twelve month period, with scope for one *emergency* MPR to be raised within the same twelve month period in either sector, subject to it meeting an additional test of "significant urgency". Please see our answer to Question 1 above for more detail.

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

No, we do not believe that it would be appropriate for Ofgem to set either a two year or a complete moratorium on subsequent modification proposals relating to issues that were considered as part of a MPR. We do not believe that such a moratorium would be practical to implement, for example all modification proposals would need to be assessed and those deemed relevant to a past MPR rejected. Over time, completed MPRs could cover a significant area of the market thus effectively rendering the industry code governance process obsolete in these areas.

More importantly, past experience has shown that with any significant reforms there is a need to adjust the arrangements once bedded in. For example, in the case of NETA there were several modification proposals raised and implemented in the early days which had the purpose of clarifying or streamlining processes and in some cases changing things that simply did not work, such as the notification error claims process. A moratorium as proposed by Ofgem would have prevented these incremental improvements from being implemented and would therefore clearly not be in the interests of competition or consumers. In any event, Ofgem would retain the ultimate right to approve or reject a modification proposal coupled

with a veto over a panel decision as to which Path the modification proposal should take. We do not therefore believe that a moratorium is either necessary or indeed appropriate.

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)?

We welcome Ofgem's recognition that harmonisation across the codes is not a necessary pre-requisite to establishing self-governance and indeed, we believe that there are significant risks in adopting a "one size fits all" approach to the codes. The decision making structure, panel membership and voting arrangements under each of the industry codes have been developed seperately as each code is designed to achieve different aims, with different parties, in some cases dealing with liabilities worth millions of pounds and others dealing mainly with procedural issues. They are currently fit for purpose and we believe that they will remain so under the proposed self-governance process. As such, we believe that the existing arrangements in relation to panel membership, voting procedures and thresholds under each of the industry codes should be retained. In the event that a change is required to such arrangements once the self-governance process has been established, this could be raised and progressed under the existing governance arrangements either under Path 2 or Path 3 relatively easily.

We also strongly believe that the same decision making process should be adopted for both Paths 2 and Path 3 in the interests of simplicity, transparency and cost-effectiveness. Any attempt to establish different rules for voting and differently constituted panels would be bureaucratic, complex and costly. In our view, this would be contrary to the aims of the review.

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

Many of the panels already have such representatives in place. A key requirement is that any such representative must be on equal terms with the other panel members.

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

We believe that the existing arrangements in relation to voting procedures under each of the industry codes are fit for purpose both currently and in the event of a self-governance process being introduced and should therefore be retained. Please see our answer to Question 1 above for more detail.

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?

Given that by definition it will be the less significant modification proposals that will go through the self-governance process, we believe that it is reasonable for there to be some form of threshold to be met in order to raise an appeal. However, the appeal arrangements should be clearly defined in advance to aid transparency for all market participants. In our view, a proportionate and fair approach would be to require the grounds of appeal to be specified in terms of the decision having a disproportionate impact on a particular class of signatories (this is similar to a number of existing self-governance arrangements). We agree

that if an appeal is lodged and is unsuccessful then the party raising the appeal should bear the costs. Finally, we believe that Ofgem would be the appropriate body to hear appeals to decisions made under the self-governance process.

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

A right of appeal must be available to all parties on a uniform, non-discriminatory basis.

Chapter Six

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

It is absolutely key that any package of reforms implemented safeguards all parties' rights in order to ensure that an individual party or indeed industry as a whole is not unfairly prejudiced by the reforms. To maintain a proportionate and fair regulatory framework, we believe that as a minimum an individual, automatic right of appeal against Ofgem / MPR-lead modification proposals should be introduced. Please see our answer to Question 4 under Chapter Four for more detail.

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

In order to ensure that the package of reforms proposed by Ofgem delivers cost savings compared to the status quo it is essential that MPRs are undertaken on a proportionate basis. We therefore believe that there should be an explicit restriction placed on the number of MPRs that Ofgem can undertake and we would suggest a limit of say, one MPR in electricity and one MPR in gas in any twelve month period, with scope for one *emergency* MPR to be raised within the same twelve month period in either sector, subject to it meeting an additional test of "significant urgency".

In addition, Ofgem's analysis shows that modifications not dealt with through the MPR route might be split roughly equally between Paths 2 and 3. As a consequence, with roughly half of modification proposals likely to be dealt with through self-governance rather than going to Ofgem for a decision, this should deliver significant cost savings to Ofgem which we would hope to see reflected in Ofgem's budget requirements going forward.

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

It is absolutely vital that any reforms introduced represent an improvement to the status quo. We firmly believe that this would require the two additional safeguards outlined under Questions 1 and 2 above to be introduced as part of the package of reforms.

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

The introduction of MPRs would need to be coupled with the introduction of appropriate safeguards which we have outlined above. In addition, MPRs would need to be viable, legally robust and transparent. In our view, this would require Ofgem to explicitly take the lead by undertaking the review (with full and proper consultation, cost benefit analysis,

regulatory impact assessments, etc.), drafting the modification proposal(s) necessary to implement the conclusions of the MPR including the production of legal text and finally, raising the code modification proposal to the relevant code panel for assessment. As noted in the paper, this would require Ofgem to be vested with the power to raise code modification proposals directly to panels. For the avoidance of doubt, without this explicit transparency and legal certainty, we would consider maintaining the status quo to be the only feasible option set out in Ofgem's paper.

Scottish & Southern Energy
26/2/09