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Our Reference:

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Dear Mark,

Code Governance Review: The Role of Code Administrators and Small Participant/Consumer Initiatives

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

Overall, we believe that the industry codes work well and we would urge Ofgem to resist introducing unnecessary or costly change for little benefit. For example, a greater reliance on consultants or a move to a “thick” code administrator model for some of the smaller, more procedural codes could lead to a significant increase in costs which outweigh any perceived benefit. It is absolutely vital that any changes proposed must be subject to a full and proper cost benefit analysis. We believe that centralised costs should be minimised where possible in the interests of competition and ultimately customers.

We would also caution against adopting a “one size fits all” approach across the individual codes. We do not believe that harmonisation across the codes, for example in terms of funding arrangements and corporate governance, is a necessary pre-requisite to securing a transparent, effective and proportionate code governance regime. Indeed, such an approach could result in reduced flexibility and effectiveness, again with higher associated costs.

Against this background, we comment on the role of code administrators, the development of a code of practice and small participant/consumer initiatives in turn below. We have also set out our detailed answers in response to Ofgem’s specific questions in the attached Appendix.

The Role of Code Administrators

We believe that an effective code administrator must satisfy two main high level operating principles, as follows. First, all code administrators should operate at arms length from the licensee and their commercial interests. Such independence can be achieved through effective management unbundling and ring-fencing of the appropriate activities. To this end, we would support a review of the code administration arrangements for the CUSC.

However, we would be strongly opposed to the STC being brought within the scope of this review as it is a tripartite agreement with legally defined property rights defining how the parties carry out their licence obligations. The arrangements in the code are purely procedural between the parties, do not affect other industry players and in any case are subject to regulatory oversight. As such the STC should not form any part of the review of the multi-participant codes.

Second, the funding arrangements of all code administrators (whether by direct pass through of costs, service level contracts or price control funding) should be transparent, accountable and auditable. As a consequence, we believe that where code administrators are funded through price controls it should be a clearly defined, discrete term in the allowed revenue formula.

Code of Practice for Code Administrators

We would be firmly opposed to the development of a binding code of practice applying to all code administrators. The governance structure, panel membership, voting arrangements and the role of code administrator under each of the industry codes have been developed separately as each code is designed to achieve different aims with different signatories. As such, there are necessary checks and balances that need to be incorporated within each code but they also need to be appropriate to each code. For example, a code dealing with liabilities worth millions of pounds requires a different level of control to a mainly procedural code. We therefore do not believe that developing a code of practice applicable across all the code administrators would be appropriate or indeed beneficial. In our view, such a code of practice would create another level of regulation (whether binding or voluntary) which could result in reduced flexibility, effectiveness and higher associated costs with little additional benefit.

Small Participant / Consumer Initiatives

We have no objection in principle to additional measures being introduced to enable small participants, new entrants and consumer representatives to better engage with the code governance arrangements, subject to the measures delivering a clear overall improvement to the existing arrangements. In our view Option 1, involving incremental change to the existing arrangements, would deliver improvements to the existing governance arrangements in a pragmatic and flexible manner without significant additional costs being imposed on industry and ultimately customers.

However, we believe that Options 2 and 2a set out in Ofgem's paper (establishing a separately funded and administered advocacy panel) would represent a disproportionate and costly response to the perceived issue of a lack of small participant and consumer involvement. Options 3 and 4 (Ofgem's consumer challenge group and placing a direct duty on code administrators to provide an advocacy role) would also involve a significant increase in costs which would feed through to market participants and in turn customers. Clearly, any measure introduced to facilitate the involvement of small participants, new entrants and consumer representatives in code governance must be subject to a vigorous cost benefit analysis in order to ensure that the benefits of such measures outweigh the additional costs.

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

Appendix: Specific Questions by Chapter

Chapter Two

Question 1: Are the Authority's concerns regarding the quality of analysis undertaken through the code modification processes justified?

In general we do not share Ofgem's concerns regarding the quality of analysis undertaken through the code modification processes. In our view, the use of peer review of evidence (through work groups and industry consultation) and indeed the production of independent evidence provided by participants is perhaps underestimated in confirming the robustness of evidence.

Notwithstanding this, however, there is scope for improvement in some areas which we believe will occur as part of a natural progression of the existing governance arrangements, for example the introduction of the "user pays" principle in gas is likely to result in more robust analysis being produced under the UNC.

Question 2: Are some code administrators more accountable than others?

As a general principle, all code administrator functions should be run at arms length from the licensee and their commercial interests. Clearly, where this is not the case, there is potential for a lack of accountability and transparency and for a conflict of interest to arise which is not consistent with the principles of better regulation.

Question 3: We consider that code complexity is a problem, particularly for small participants, new entrants and consumer representatives. Do you agree? How can the complexity be reduced?

The industry codes are complex legal documents setting out legal (and potentially significant financial) rights, obligations and duties in relation to a wide ranging, complex set of arrangements. In our view, this is necessary in order to protect the integrity of the system, market and ultimately customers.

Question 4: Do small participants, new entrants and consumer representatives find it difficult to engage with the code modification process?

In our view, sufficient assistance is available to small parties, new entrants and consumer representatives to allow them to participate fully in code governance and modification processes. In particular, we do not believe that the role of code administrators should be unnecessarily expanded in the name of small parties, new entrants and consumer representatives as this may not be the most cost-effective option. In our view, centralised costs should be minimised where possible in the interests of competition and ultimately customers.

Our preference would therefore be to maintain the existing "thin" administrators for the more procedural codes and not seek to extend the central administrator's role as an implicit means of cross-subsidising the smaller market participants.

We consider that perhaps a bigger problem for new entrants is the sheer volume of modifications. In a mature market we do not believe that this is sustainable and we would therefore advocate a mechanism to limit/prioritise important modifications, perhaps by

introducing charges for raising modifications. We acknowledge that Ofgem has in the past not been keen on this, but – fundamentally – unless the volume issue is addressed, no amount of central “help” from the code administrators is going to limit the burden on new entrants to any significant degree.

Chapter Three

Question 1: Do you agree that the quality of analysis in code modification reports could be improved? Should the role of the code administrator be changed to help enhance the quality of code modification reports?

As we have stated above, we agree that there is scope for improvement in some areas. To the extent that we have experienced issues with the administration and quality of reports, these have been more evident where the secretariat function is not at arm’s length from the licensee, for example we have seen last minute changes to reports under the CUSC. We therefore believe that, as a general principle, all code administrator functions should be run at arms length from the licensee and their commercial interests.

Question 2: Which of the options for changing the role of the code administrator in the modification process (critical friend or active secretariat) is most appropriate? Should different options be chosen for different codes?

The decision making structure, panel membership and voting arrangements under each of the industry codes have been developed separately 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. It would therefore not be appropriate to seek to harmonise the role of code administrator across all the codes. Indeed, in our view there would be significant risks in adopting a “one size fits all” approach to the role of code administrator or the codes more generally.

Against this background, we see merit in relation to the more commercial codes such as BSC, CUSC and UNC adopting a “critical friend” approach to the role of code administrator as outlined in Ofgem’s paper. Indeed, under both the BSC (Elexon) and UNC (Joint Office) the code administrators currently undertake such a role. However, it is essential that the role of “critical friend” is independent and operated at arms length from the licensee. We therefore do not believe that the role of “critical friend” should be extended to the role of the CUSC code administrator under the present CUSC arrangements.

In addition, we do not see merit in Ofgem’s proposed “active secretariat” role for any of the codes or indeed expanding the role of code administrators from the status quo for the more procedural codes. In our view, either approach would significantly increase centralised costs for little (if any) benefit and would not be in the interests of competition or ultimately customers.

Our preference would therefore be the adoption of a “critical friend” role for the code administrators of the main commercial codes (subject to the code administrator operating independently from the licensee) and retaining the code administrators’ existing role for the remaining, more procedural codes.

Question 3: Should the roles of the administrators of the BSC, UNC, CUSC, Grid Code, SPAA and MRA in respect of central systems management be harmonised i.e. should all code administrators either be made responsible for the related systems or should this responsibility be removed from them all?

As we have outlined in our response to Question Two above, we do not believe that it is necessary to seek to harmonise the role of code administrators. Where the role of code administrator involves responsibility for central systems management, we do not see this in itself as an issue. Similarly, we have no issues where the role of code administrator is separate to the management of central systems, for example in the case of gas with the Joint Office and Xoserve respectively. As a consequence, we believe that the existing individual code arrangements are fit for purpose and we would not therefore support change (with the high level of associated costs) unless an overall net benefit could be clearly demonstrated.

Rather, in our view, the key issue is the over-riding principle of independence whereby all code administrators should be run at arms length from the licensee. Such independence would help to ensure that the necessary information on system costs, etc. would be made available in a timely fashion by the code administrator where appropriate.

Chapter Four

Question 1: Should code administrators be independent of network owners? If so, is it sufficient to have management unbundling or should the code administrator be an independent company?

Yes, as a principle, all code administrators should be run independently of network owners. We believe that such independence can be achieved through effective management unbundling and ring-fencing of the appropriate activities. There are a number of examples of effective management unbundling throughout the sector. Against this background, we would support a review of the code administration arrangements for the CUSC.

However, we would be strongly opposed to the STC being brought within the scope of this review as it is a tripartite agreement with legally defined property rights defining how the parties carry out their licence obligations. The arrangements in the code are purely procedural between the parties, do not affect other industry players and in any case are subject to regulatory oversight. As such the STC should not form any part of the review of the multi-participant codes.

Question 2: Should all the major commercial codes have the same corporate governance structures? What is the most appropriate governance structure?

No, we believe that different governance structures are appropriate for different codes. However, as a minimum, we believe that all code administrators should be run at arms length from the licensee. As a consequence, we believe that only options 2 and 3 of Ofgem's three corporate governance options for code administration are appropriate.

Question 3: Are code administrators and the management teams for CUSC, UNC and BSC sufficiently accountable in terms of their costs and performance? Do they have clearly defined objectives and measurable performance targets?

We believe that all code administrators should operate on a cost-effective, transparent and accountable basis.

Question 4: Code administrators are currently funded by cost pass through, service contracts or price controls. Which of these funding arrangements is the most transparent and accountable?

Again, we do not believe that it would be beneficial to seek to harmonise the funding arrangements of the code administrators across the codes. However, a pre-requisite of any funding arrangements should be transparency and accountability. As such, where code administrators are funded through price controls it should be a clearly defined, discrete term in the allowed revenue formula.

Question 5: Is there an argument for considering the service contract approach to funding for more codes if a degree of self governance for a code is introduced?

Where appropriate, a competitive tendering approach works well but we do not believe that such an approach is necessarily linked to the degree of self-governance that is introduced.

Question 6: Should the funding of the code administrators for the CUSC and UNC be removed from the relevant network owner price controls?

No, we do not believe that the funding of the code administrators for the CUSC and UNC should be removed from the relevant network owner. Rather, as we have set out under Question Four above, the funding should be a clearly defined, discrete term in the allowed revenue formula to aid transparency and accountability.

Chapter Five

Question 1: Should Ofgem have powers to “call in” and “send back” modification proposals? What are your views on the “call in” and “send back” options?

In principle, we would have no objection to Ofgem having the power to “call in” and “send back” modification proposals as outlined in the consultation paper. However, any such power must be clearly defined and should be consistent with Ofgem’s recent proposals on timed-out modification proposals.

Question 2: Should all code Panels have to publish the reasoning behind their recommendations?

Yes.

Question 3: Should code administrators be able to raise modifications themselves? If so, should there be limits on what modifications they can raise or should they have to gain the consent of the code Panel to the raising of the modification?

No, allowing code administrators to raise modification proposals directly would impact on their level of independence. In our view, a modification proposal should have an industry sponsor/proposer. However, this does not preclude the code administrators from undertaking analysis and development work in support of a modification proposal, such as housekeeping modifications, where it follows on from the work of an issues group or is clearly in the interests of industry. Such a modification proposal would then require to be formally raised by an industry party or the panel.

Question 4: Would it be useful to develop a code of practice applying to all code administrators? Should it be voluntary or binding?

We would be firmly opposed to the development of a binding code of practice applying to all code administrators. As we have stated above, the governance structure, panel membership, voting arrangements and the role of code administrator under each of the industry codes have been developed separately as each code is designed to achieve different aims with different signatories. As such, there are necessary checks and balances that need to be incorporated within each code but they also need to be appropriate to each code. For example, a code dealing with liabilities worth millions of pounds requires a different level of control to a mainly procedural code. We therefore do not believe that developing a code of practice applicable across all the code administrators would be appropriate or indeed beneficial. In our view, such a code of practice would create another level of regulation (whether binding or voluntary) which could result in reduced flexibility, effectiveness and higher associated costs with little additional benefit.

Question 5: What are the most appropriate mechanisms to evaluate the performance of code administrators? Is a scorecard approach appropriate?

It is entirely appropriate to undertake some form of performance evaluation of code administrators. A scorecard approach as outlined in the consultation paper would be appropriate, subject to it being sufficiently flexible to allow code differences to be fully taken into account and judged by independent review.

Chapter Six

Question 1: Do small participants, new entrants and consumer representatives face significant hurdles in engaging with the code governance processes?

Please see our answer above to Question Four, Chapter Two.

Question 2: What are the key issues that need to be addressed in order for small participants and others to better engage with the code governance processes?

Please see our answer above to Question Four, Chapter Two.

Question 3: Do you have any views on the options highlighted in this chapter? Do you have any views on the advantages and disadvantages discussed under each option?

We have no objection in principle to additional measures being introduced to enable small participants, new entrants and consumer representatives better engage with the code governance arrangements, subject to the measures delivering a clear overall improvement to the existing arrangements. In our view Option 1, involving incremental change to the existing arrangements, would deliver improvements to the existing governance arrangements in a pragmatic and flexible manner without significant additional costs being imposed on industry and ultimately customers.

However, we believe that Options 2 and 2a set out in Ofgem's paper (establishing a separately funded and administered advocacy panel) would represent a disproportionate and costly response to the perceived issue of a lack of small participant and consumer involvement. Options 3 and 4 (Ofgem's consumer challenge group and placing a direct duty on code administrators to provide an advocacy role) would also involve a significant increase

in costs which would feed through to market participants and in turn customers. Clearly, any measure introduced to facilitate the involvement of small participants, new entrants and consumer representatives in code governance must be subject to a vigorous cost benefit analysis in order to ensure that the benefits of such measures outweigh the additional costs.

Question 4: Which options, if any, do you consider will allow small participants and others to engage better with the code governance processes?

Please see our answer to Question Three above.

Question 5: Are there other options which we have not yet considered which may assist small participants and others to play a fuller part in the codes governance processes?

Please see our answers to Question Four, Chapter Two and Question Three above.

Scottish & Southern Energy
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