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Code Governance Review: Major Policy Reviews and Self-Governance - Initial Proposals

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Target audience: Gas and electricity industry participants, consumer representatives, code administrators and other interested parties

Overview:

The industry codes provide a contractual framework containing most of the technical and commercial rules by which the gas and electricity industries operate. The Codes Governance Review ("the Review") aims to ensure that the codes are able to respond effectively to the significant challenges facing these industries. In December 2008 we consulted on a package of proposals to reform the codes arrangements to facilitate the delivery of major policy reform on codes issues and to introduce greater self-governance into the process. Having taken careful account of responses to that consultation, we are now presenting our initial proposals for Major Policy Reviews ("MPRs") and self-governance.

Under the proposed MPR process, the Authority could, after thorough consultation, require licence holders to raise code modification(s) consistent with its MPR conclusions. The MPR process would not alter the existing rights of appeal against the Authority's code modification decisions. Under the proposed self-governance process, decisions on modifications that would be likely to have a minimal impact on consumers, competition or on matters relevant to our other statutory duties would be made by industry participants rather than Ofgem, which we believe would bring significant better regulation benefits.

Greater coordination and leadership by Ofgem is necessary if the gas and electricity industries are to meet the environmental and security of supply challenges facing them. We believe that these proposals are a proportionate means of facilitating this.

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Context

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 Review.

The industry codes provide a contractual framework containing most of the technical and commercial rules by which the gas and electricity industries operate. 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 introduction in 2005 of a right of appeal to the Competition Commission. Since the Review began, concern has increased about whether the present governance arrangements enable the codes to deliver important reforms in the face of key challenges such as climate change and security of supply. This has most recently been demonstrated in the case of electricity transmission access, where the codes arrangements have failed to deliver a range of viable alternative reform proposals in a timely manner. 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 Review is considering what changes are required to deliver these objectives. The Review comprises several work-strands as listed in the table below.

Work-strand	**Update**
Major Policy Reviews and self-governance	Ofgem initial proposals issued today – responses due 18 September 2009
Role of Code Administrators and small participant/consumer initiatives	Ofgem initial proposals issued today – responses due 18 September 2009
Charging methodologies	Further consultation to be issued shortly
Code objectives and the environment	Ofgem consultation issued 16 June – responses due 29 July 2009
Complexity and fragmentation – Code Administrators Working Group	Consulted on draft CAWG report in April 2009; update letter to be issued shortly.

This document is related to the work-strand on MPRs and self-governance.

Associated Documents

- Open letter announcing code governance review (Ref: 284/07), November 2007

www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/Open%20letter%20announcing%20governance%20review.pdf

- Corporate Strategy and Plan 2008-2013 (Ref: 34/08), March 2008

www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/CORPORATE%20STRATEGY%20AND%20PLAN%2028%20MARCH%202008.pdf

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

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

- Codes governance review: major policy review and self-governance (Ref: 172/08), December 2008

http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/MajPol_SelfGov_condoc_191208.pdf

- Codes governance review: role of code administrators and small participant/consumer initiatives (Ref 173/08), December 2008

http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/Code_admin_condoc_191208.pdf

- Corporate Strategy and Plan 2009-2014 (Ref: 34/09), March 2009

http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/Corporate%20Strategy%20March%202009.pdf

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Summary

This consultation document presents Ofgem's initial proposals for the delivery of major policy reform and self-governance under the industry codes.

Separately, we have published proposals to improve the effectiveness of code administrators and to facilitate engagement by small participants and consumers in the governance process.

Over recent years, the existing codes governance arrangements have been effective at delivering incremental reforms. However, it is not clear that the present governance arrangements enable the codes to deliver important reforms in the face of key challenges such as climate change and security of supply. This has most recently been demonstrated in the case of electricity transmission access, where the codes arrangements have failed to deliver a range of viable alternative reform proposals in a timely manner.

We believe that our proposals for a **major policy review process** would better enable the industry to meet these challenges as it would allow the case for strategic reforms to be considered and, if necessary, progressed in a coordinated and timely manner. Strategic policy issues would be considered in a single process and thus reduce the need for multiple, piecemeal code modifications and multiple assessment processes by industry, code administrators, code panels and Ofgem. Consumers would also obtain the benefits of policy reforms in strategic areas at an earlier stage.

Meanwhile, the proposed **self-governance arrangements** should ensure that Ofgem resources are focussed on those issues that are more material to competition, consumers or our other statutory duties, with consequential better regulation benefits. Indeed, a significant proportion of modification decisions could be addressed by self-governance, potentially reducing costs and facilitating faster implementation of change proposals.

Our view remains that this package should significantly improve the efficiency with which policy is made and implemented while at the same time protecting the rights of stakeholders to put their views to Ofgem and to appeal any subsequent code modification decisions.

The Major Policy Review (MPR) process

We would not expect to conduct more than one or two MPRs in a financial year.

We recognise that the introduction of the MPR process would provide the Authority with more control over policy development. We also recognise that there is opposition to this from within industry, many of whom consider that Ofgem would be acting as "judge jury and executioner" under the MPR process.

While we do not consider this to be a fair representation of our proposals, we have listened to those concerns and we recognise how important it is to ensure there is a proper system of checks and balances. It is our intention that the MPR process

would be fully consultative. In cases where, following an MPR, the Authority directs parties to raise modification proposals, there would be further consultation on the details of the modification proposals and the Authority would retain an open mind throughout.

Clearly it is also important that there is sufficient accountability for Ofgem under the MPR proposals. We note that the existing mechanisms for seeking judicial review could apply to decisions taken by Ofgem during the MPR process. Further, although relevant licensees would be required to draw up modification proposals that reflected any MPR-related directions that may be issued, code panel voting requirements would not be amended to require code panel members to vote in favour of those proposals. Affected parties would therefore be entitled to a full merits appeal of decisions on MPR-related code modification proposals to the Competition Commission in the same way that current decisions can be appealed. We do not consider that the MPR process would alter the way in which the Competition Commission conducts an appeal nor that an appeal would be any more or less extensive than for other appealable decisions.

We have discussed the MPR proposals with the Competition Commission. The Competition Commission noted that our proposals would not affect code participants' rights of appeal against our code modification decisions under Energy Act and did not anticipate that the proposals, if implemented, would affect the manner in which the Competition Commission conducts any such appeals.

Key changes to the MPR framework

We have proposed changes to the MPR framework to address some of the concerns raised in our December consultation. These changes should enhance the policy development and consultation process, introduce more flexibility and help to ensure that the MPR framework is transparent. They are:

- **a 'time window' for industry participants to raise changes**. We are proposing that code parties (including relevant consumer representatives) should be free to raise alternative modification proposals *within a defined time window* following the publication of MPR-related directions;
- **urgent code modification proposals**. We propose that the existing rights of code parties (including relevant consumer representatives) to request Ofgem's consent *at any time* to raise an urgent modification proposal should be available in relation to matters that are the subject of an MPR; and
- we propose that **the Authority should be able to alter any MPR-related direction that it has issued**, for instance if new information came to light after it had issued its original MPR-related directions.

Self-governance

We also continue to propose that code modification proposals that are likely to have minimal impacts on competition, consumers or matters relevant to our other statutory duties could be dealt with through a new self-governance process.

We are consulting on the MPR and self-governance proposals as a package.

1. Introduction

Background

1.1. In November 2007 we initiated the Review with an open consultation. We commenced the Review because:

- the major codes had been introduced some time ago and since then there had been significant changes in the market and regulatory landscape, which raised 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 had evolved, in particular with the entry of smaller players including renewable and distributed generators; and
- concerns had been expressed by small market participants that the existing code arrangements were too complex and inaccessible, particularly for the smaller new entrants, and that weaknesses in the governance regime prevented industry and consumers getting full value from the code arrangements.

1.2. 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. Ofgem considers that the codes arrangements have been severely tested in key strategic reform areas that are significantly impacted by public policy issues such as sustainable development and security of supply. In some cases, the codes arrangements have hindered progress in key areas of policy development. Electricity cash-out and transmission access reform are two such areas.

1.3. It is important to emphasise that, given the evolving nature of the market as well as developments in the Government's energy and sustainability policies, it is very likely that further strategic issues will arise over the coming years which have significant impacts on the codes arrangements.

1.4. In June 2008 the Authority decided to initiate a major programme of work to ensure that the governance arrangements remain fit for purpose.[1] The main objective of this work is to develop a set of code governance arrangements that deliver benefits to consumers and industry participants on key strategic policy issues

[1] See Ofgem's publication on the scope of the review published in June 2008.

and that lead to more effective and efficient decision-making. In practical terms, this means making better use of Ofgem and industry resources in the development of the codes, code decision-making and ensuring that Ofgem's resources are focused on issues likely to impact on competition, or consumers or on matters relevant to our other statutory duties.[2]

1.5. In December 2008 we consulted on a framework in which Ofgem would consult, by way of an MPR, on the need for strategic reform in key areas. We proposed that after completing an MPR, Ofgem should be able to issue directions to licence holders to raise modification proposals consistent with the conclusions of Ofgem's MPR. 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 minimal impacts on consumers, competition security of supply and sustainable development. The Authority indicated that it viewed the two reforms as a single package. We consulted stakeholders on that basis and stated that the proposed package represented a significant improvement on existing arrangements.

Purpose of document

1.6. This document sets out our initial proposals for reform, building on the previous consultation document, and consults on our assessment of the package of reforms as compared with existing arrangements. In order to assist stakeholder understanding, we will in August publish draft modifications to licence conditions that represent one way of giving effect to our proposals. We seek views on our proposed process and will also welcome views on the licence drafting once it is published.

1.7. We welcome written responses by 18 September 2009.

Structure of document

1.8. 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 our initial proposals for determining the appropriate pathway for code modification proposals under a reformed framework;
- chapter 4 sets out our initial proposals for the MPR process; and
- chapter 5 sets out our initial proposals for the self-governance process.

1.9. Appendix 2 contains our assessment of the impact of the proposed package of reforms and how it compares with existing arrangements.

[2] The full list of our review objectives is in the context page at the beginning of this document.

2. Key issues and objectives

Chapter Summary

This chapter sets out the rationale for the reform of the industry codes governance arrangements and describes the high level framework for reform. Building on responses to the December 2008 document, we again assess the case for reform against the objectives of the Review.

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 MPR process enable key strategic issues 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 MPR 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. In recent years the code arrangements have worked well to deliver incremental change. However, with the increasing emphasis on sustainable development, climate change and security of supply, the nature of the regulatory issues facing industry participants through the codes arrangements is becoming more challenging.

2.2. Recently the code governance arrangements have been severely tested in key strategic reform areas that are significantly impacted by public policy issues including sustainable development and security of supply. These areas include electricity transmission access and electricity cash-out.

2.3. In our December 2008 document we expressed our concerns that progress in these areas has been made difficult or has been delayed, for several reasons including multiple proposals being raised, duplication in assessment processes and piecemeal development of proposals. There have also been strong divergences in the commercial interests of different players, some of whom may be opposed to reform. Whilst a diversity in viewpoints is welcome, and it is important that parties have the opportunity to express these views, as we noted in our December 2008 document, it should not be a pre-requisite of reforms that all parties agree on the need for reform or the nature of the reforms.

2.4. For both electricity cash-out and electricity transmission access, renewable generators and smaller market participants have frequently raised concerns with Ofgem regarding the progress of reform. Furthermore, in the case of electricity transmission access, the delays have raised concerns within Government regarding the ability of the code arrangements to deliver reforms that would enable renewable generators to access the electricity transmission network. In view of this, the Government took powers under the Energy Act 2008 to amend the codes to deliver electricity transmission access reform.

2.5. Over recent months, the delays experienced on the Transmission Access Review (TAR) have been more acute. For example, in late March and early April, the CUSC Panel prevented a TAR modification proposal being raised and sent to consultation with industry participants. The decision taken by the CUSC Panel has prevented interested parties from expressing their views on this proposal and has prevented the proposal from being progressed through CUSC processes to Ofgem for decision. We therefore wrote to the Secretary of State recommending that he should use his Energy Act powers to take control of the transmission access reform process. Ofgem considers that the decision by the CUSC Panel to prevent further work on this modification underlines our concerns about the way that major reforms are governed by the industry processes. We note that on 15 July the Secretary of State indicated that he would use his Energy Act powers to drive through reforms in this area.

2.6. In summary, we consider that these past initiatives have demonstrated that the codes process is not always capable of dealing with major strategic issues and Government influenced policy challenges particularly where there have been strong divergences in views across industry.

2.7. Whilst the problems currently being experienced in the context of electricity transmission access demonstrate the need for reform, it is also important to look forward when considering the objectives of the Review and the benefits that an MPR process could deliver. In this respect we would emphasise that given the evolving nature of the market as well as developments in Government policies on energy, security of supply and the environment, it is very likely that further strategic issues will arise over the coming years. For example, over the next few years, the industry will be faced with the challenges of implementing a new smart metering framework. In addition, the introduction of cross-border European codes in the gas and electricity sectors will also provide challenges that will need to be addressed.

Respondents' views

2.8. There were mixed views in response to our assessment of the deficiencies of the codes governance arrangements that we set out in the December 2008 document. Some respondents agreed with Ofgem both that the codes had not proved an effective mechanism for managing strategic reform and that radical change was necessary in order to facilitate an effective industry response to the environmental and security of supply challenges facing the country. Others, however, believed that the governance regime had delivered substantial changes, particularly where proposals enjoyed widespread industry support. Some of these respondents

suggested that some of the weaknesses of the current regime that we listed in the December 2008 document were in fact strengths.

2.9. Some respondents suggested that a key benefit of the current regime was that multiple proposals could be put forward since this would ensure that the industry and Ofgem had the widest possible number of alternatives to evaluate. It was also suggested that the piecemeal development of proposals, with new proposals being raised on similar issues several months apart, enabled the industry and Ofgem to take account of evidence and views that would not have been available when the first proposal was raised. Several respondents noted that it was entirely legitimate for different players to adopt views that reflect their varying commercial interests.

2.10. Many respondents, while agreeing that there was scope to improve the workings of the governance regime, did not believe that our proposals offered a proportionate solution. Several argued that improvements could be made within the current process and without the need for an MPR mechanism. These respondents felt in particular that greater engagement from Ofgem during the development of modification proposals would be beneficial in terms of minimising wasted effort on proposals that Ofgem would be unlikely to approve and to ensure that the analysis undertaken was likely to assist Ofgem in reaching a decision.

2.11. Some respondents argued that the MPR process represented a significant rebalancing of decision-making powers between the industry and Ofgem. They were concerned it would be undesirable for Ofgem to be in the position of ruling on modifications that it had either drafted or directed the industry to draft. Several respondents asserted that Ofgem would be acting as "judge, jury and executioner". It was pointed out that the Competition Commission, in its decision on E.ON's appeal in relation to gas offtake, had already expressed concerns about checks and balances where Ofgem was perceived as the source of a modification proposal.

2.12. Some respondents expressed concern that there would be insufficient opportunity for consultation during the MPR process. It was also suggested that if Ofgem did not publish and adhere to strict timetables the MPR process would not deliver results any quicker than the existing governance regime. Some argued that there should be a right of appeal on the merits of our MPR conclusions.

2.13. These respondents were also concerned that code panel members would be prevented from voting freely in relation to the code modifications that might arise following an MPR process, and that this in practice would reduce the possibility of appealing our decisions to the Competition Commission. They also suggested that the Competition Commission itself would be restricted in its handling of any subsequent appeals. However, some of these respondents also signalled that they might be persuaded to support an MPR process if Ofgem could provide satisfactory answers to these issues.

2.14. By contrast, there was a consensus in favour of our proposals to introduce self-governance. All respondents agreed with our view that it was sensible to allow industry participants to manage the progress of modifications that would have only a

minimal impact on consumers or competition. Respondents generally agreed that a large volume of the modification proposals had little impact on consumers and that code parties could take decisions on them. A few respondents did however suggest that our back-casting exercise might have over-estimated the proportion of code modifications that would have gone through the self-governance process. It was also noted that it would not always be a simple matter to assess competition and consumer impacts at the outset when a filtering decision would have to be made.

2.15. Many respondents said that Ofgem should not treat MPR and self-governance as an inseparable package. They believed that, because self-governance was desirable in its own right, we should introduce it regardless of whether we pursue the MPR element of our proposals.

2.16. Most respondents stated that there was a good case for retaining an improved *status quo* path and that the package should be applied to all codes. Some respondents recommended phasing their implementation (starting with the Uniform Network Code, the Balancing and Settlement Code and the Connection and Use of System Code, on the basis that these codes would more likely be subject to an MPR).

Ofgem's position

2.17. The changing regulatory and market landscape suggests that there are likely to be other important strategic code reform challenges in the future. For example, as we have noted above, the evolving nature of the electricity and gas sectors, in part in response to Government initiatives, are likely to have significant impacts on the codes arrangements. We believe that it is necessary now to take forward major changes to the code governance regime that would, if implemented, ensure that the case for introducing strategic reforms could be examined in a comprehensive and timely manner.

2.18. We believe that our proposals are necessary and proportionate. Under the current arrangements we have some ability to influence change indirectly; however, our role is largely restricted to a decision-making body at the end of the modification process. By contrast, under the proposed MPR framework, we would adopt a more transparent role in examining the case for major reform. It is also notable that under the proposed European codes arrangements, the Agency for the Cooperation of Energy Regulators will take a more pro-active role and would be able to raise modification proposals itself to the proposed cross border codes.

New powers with full accountability

2.19. We recognise that, under the MPR arrangements, the Authority would be taking more control in areas where there are key strategic policy issues. However, for the reasons we have outlined above, we consider that this represents a necessary and proportionate rebalancing of powers from an existing framework where the Authority's role is more limited, particularly given the nature of the challenges faced by the electricity and gas industries. We recognise that it is very important that sufficient checks, balances and accountability exist in the process. We are aware of

a perception that there was insufficient accountability for Ofgem in the arrangements set out in December 2008. Indeed, as noted above, some respondents claimed that we would be acting as "judge, jury and executioner" under the MPR process. We do not consider this to be a fair representation of our proposals.

2.20. We intend that the MPR process would be fully consultative. In particular, we would consult with industry participants on the scope of the MPR, the issues to be addressed and the possible options for reform, before proceeding to issue any directions on parties to raise proposals. The process would be highly transparent and we would also expect to carry out impact assessments on any proposals that are progressed. Our objective would be to reach well-informed and fully-reasoned conclusions.

2.21. When the MPR is complete, if we have issued directions on parties to raise modification proposals, there would be further consultation with code parties on these proposals. As such, the process of consultation would not end with the completion of the MPR. Rather, the consultation process would continue until decisions are reached on the relevant modification proposals. In addition, where code modifications are considered necessary, it would be important that those modifications are effective and workable. In order to achieve this it would be essential for Ofgem to maintain an open mind throughout the process.

2.22. On the matter of checks and balances, we note that the existing mechanisms for seeking judicial review could apply to decisions taken by Ofgem during the MPR process. We are also clear that, although relevant licensees would be required to draw up modification proposals consistent with Ofgem's MPR conclusions, and steer them through the code modification process, we do not propose changes to the governance arrangements to require code panellists to vote in favour of those proposals. Rather, code panel members would be free to vote as they wish (consistent with their responsibilities as code panellists). Affected parties would therefore be entitled to a full merits appeal of decisions on MPR-related code modification proposals at the Competition Commission to the same extent as appeals may currently be heard.

2.23. Finally, in considering any appeal, we do not believe that the Competition Commission would be restricted in its ability to undertake a review of the code modification by the MPR process. Indeed, we consider that to the extent that the modification reflected the conclusions of an MPR, the Competition Commission would be able to evaluate the MPR conclusions as part of the appeal.

2.24. We have held discussions with the Competition Commission about our MPR proposals. The Competition Commission noted that our proposals would not affect code participants' rights of appeal against our code modification decisions under Energy Act and did not anticipate that the proposals, if implemented, would affect the manner in which the Competition Commission conducts any such appeals.

The importance of consultation

2.25. It is important that parties with divergent views should have the opportunity to express these as part of the debate on major policy reform. Some respondents have inferred from Ofgem's proposals that we do not welcome diverse views on policy issues within the codes process. This is not the case. Ofgem welcomes and values the views received by respondents through consultation. The views received through industry consultation under the MPR framework should help to shape policy proposals and ultimately assist Ofgem in evaluating the modification proposals that are brought forward. Indeed, it is vitally important that all parties' views are properly considered by Ofgem in its decision-making process.

2.26. As we have noted previously, however, it should not be a pre-requisite of reforms that all parties agree on the need for reform or the nature of the reform that should be progressed. Provided that all parties have been properly consulted and that robust analysis has been undertaken, progress should not be unnecessarily held up by divergences in views.

2.27. Our proposals are not intended to prevent or stifle debate. Instead, they are intended to promote debate through a transparent, consultative framework that provides a more efficient process for policy-making and reduces the potential for delays, such that major reforms can be delivered in a more timely manner. We have also proposed changes to the MPR framework in order to enable the timely raising of alternative modification proposals after an MPR direction has been issued. These proposals are intended to enhance industry input and are discussed in detail below.

The ability for Ofgem to influence change

2.28. We do not agree with respondents that the current arrangements are sufficient for Ofgem to progress change. Ofgem has the ability to engage in code modification discussions to influence change and indeed can indirectly influence change. However, Ofgem does not have the ability to initiate the development of modification proposals and the MPR process introduces this facility through an open, consultative and transparent framework.

Self-governance

2.29. We agree with those respondents that indicated that industry participants should manage those modification proposals with minimal impacts on competition, consumers or other matters that fall within Ofgem's statutory duties. At present, Ofgem deals with a large number of modification proposals that have minimal impact on consumers and competition. There is potentially unnecessary duplication of work by both the industry and Ofgem in assessing such proposals. Many are housekeeping modification proposals, but there are a significant number that introduce systems and process changes or minor governance changes that could be managed by industry without Ofgem involvement. Indeed, we consider that a significant proportion of the modifications currently decided on by Ofgem could be managed in this way.

Summary of Ofgem's proposals

2.30. We are proposing that significant reforms requiring changes to the industry codes should in future be developed through a new MPR process. This is described in more detail in chapter 4.

MPR framework

2.31. We continue to propose an Ofgem-led MPR process which could be initiated either when Ofgem identifies a significant policy issue or when Ofgem considers that a code modification, raised in the usual way, gives rise to significant policy issues.

2.32. We would seek to give as much prior notice as possible of our intention to undertake an MPR. For example, we would be likely to indicate in our Corporate Strategy and Plan any intention to conduct an MPR in the forthcoming financial year and to set out a timetable for delivery. Interested parties would of course be free to make representations as part of our planning process that an issue should be dealt with through the MPR process. It will also be open to interested parties to argue that a code modification gives rise to such issues. The decision to undertake an MPR would, however, reside with Ofgem.

2.33. Ofgem would consult thoroughly during the MPR process, as it would for any other major policy initiative that it was undertaking. We would seek views on the scope of the MPR, the issues to be considered and the options for reform. Stakeholders would therefore have ample opportunity to influence the policy process before we reach any conclusions. At the end of the MPR, Ofgem would publish written conclusions. It is entirely possible that, after thorough consultation, we might conclude that no regulatory action is required. On the other hand, we might conclude that changes are necessary or appropriate. In the latter event, we propose that the conclusions of the review should take the form of detailed policy principles. This would be accompanied or followed by directions to one or more licensees to raise modification proposals that are consistent with those principles. We also propose that Ofgem has the power to draft appropriate modifications in the event that the relevant licensee(s) fails to develop proposals that are consistent with the direction provided by Ofgem.

Key changes to the proposed MPR framework

2.34. As part of our initial proposals, we have made three key changes to the MPR framework on which we consulted in December 2008. These changes are summarised below and discussed in more detail in chapter 4. They are:

- **a 'time window' for industry participants to raise changes**. We are proposing that code parties (including relevant consumer representatives) should be free to raise alternative modification proposals. However, we propose that Ofgem should have the ability to prevent insufficiently developed alternative proposals being raised. We consider that this change would further improve the

policy development process by enabling code parties to raise sufficiently developed alternative proposals;

- **urgent code modification proposals**. We propose that the current rights of code parties (including relevant consumer representatives) to request Ofgem's consent *at any time* to raise an urgent proposal to modify existing code arrangements should be available in relation to matters that are the subject of an MPR. This would provide more flexibility for industry participants and Ofgem to deal with urgent issues that arise about the arrangements that are the subject of an MPR; and

- **ability to change the Authority's direction**. We are also proposing that the Authority be able to issue further directions, some of which might alter the content of previous directions issued following an MPR. This is because there are likely to be instances where policy proposals evolve and develop following the conclusion of an MPR (for example, once the detailed policy options are being developed through modification proposals) and the Authority would need the flexibility to change its directions to reflect these developments where necessary and in a manner consistent with the Authority's statutory duties.

2.35. We believe that the proposed MPR process would address the deficiencies in the ability of the existing code arrangements to deliver major policy reforms. It should bring efficiency benefits by reducing the potential for Ofgem and industry resources to be taken up with multiple piecemeal modification proposals on significant issues. The MPR process should enable parties to engage with a single process covering all aspects of a significant policy change including code, licence and, where applicable, charging methodology changes. This single process should reduce duplication in the analysis that might otherwise have to be carried out by Ofgem and industry under the normal modification process.

The self-governance framework

2.36. We are also proposing that code modification proposals meeting defined suitability criteria could be dealt with by a new self-governance process. This would reduce the role of Ofgem in modifications that have minimal impacts on matters that fall within Ofgem's statutory duties, such as consumers or competition. We consider that this could increase the efficiency of the modification process with consequential better regulation benefits.

3. Determining the code modification pathway

Chapter Summary

This chapter describes the proposed filtering process for determining which Path modification proposals should follow.

Question 1: Do you agree that, once a modification has been raised, the filtering decision should be taken by the relevant panel, subject to an Ofgem veto that could be deployed at any point before a final decision on the proposal has been made?

Question 2: Do you agree with the proposed criteria that should be applied to assessing whether a modification falls into Path 1 or Path 2? Is further guidance necessary?

Question 3: Do you agree with our proposals for redirecting modification proposals between Paths 3 and 2?

Question 4: Should code parties be able to make requests to Ofgem at any time that they can raise an urgent modification proposal to existing arrangements that are the subject of an MPR? Do you agree that non-urgent modifications to existing arrangements that are the subject of an MPR should be subsumed within the MPR?

Description of filtering process

3.1. In our December 2008 document, we noted that if the package of reforms were implemented, there would need to be a filtering process for determining which of the three Paths a modification assessment should follow. For any modification proposals that did not fall within a Path 1 MPR process, a set of criteria would be applied to determine whether the proposal should follow Path 2, in which Ofgem would ultimately decide whether or not to approve a modification. If the modification did not meet the Path 2 criteria it would follow the Path 3 self-governance route.

3.2. We noted that an MPR process could be triggered by a modification proposal, by Ofgem identifying a key deficiency in the codes arrangements or where, for example, the codes are likely to be affected by EU or UK Government-led policy initiatives. We also noted that, in designing a filtering process, two key issues arose: who would take the filtering decisions and on what basis?

Options for the filtering process

3.3. In December 2008 we set out two options for designing the filtering process. The first option envisaged Ofgem deciding which Path a modification should follow. Under this approach, once a code modification was raised, it would be submitted to Ofgem. As a first step Ofgem would consider whether the modification met the criteria for Path 1. If not, Ofgem would consider whether the criteria for Path 2 had

been met. Modifications which did not satisfy either set of criteria would default to self-governance arrangements.

3.4. We did not propose that Ofgem would consult on its filtering decision on the basis that each Path would involve extensive consultation and appeal rights. However, we noted both that Ofgem would give full reasons for its decision and that the filtering decision would thus be similar in some respects to our current role in deciding whether to grant urgency status to a modification proposal.

3.5. As an alternative, we sought views on whether the relevant industry panel should make the filtering decision, subject to an Ofgem veto. Under this approach, Ofgem would have the right to override the panel decision at any point during the industry's assessment process. For example, in the case of proposals being considered under Path 3, Ofgem would be able to redirect them to the Path 2 process if it became clear that the content of the modification was not suitable for the self-governance process. We stated that such flexibility was important even at the cost of some uncertainty for industry. We stated that if we wished to redirect a modification into Path 2 we would seek to do so as soon as possible.

3.6. We noted that, under this option, industry would not be asked to consider whether a modification should be made subject to a Path 1 MPR. Rather, the 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 an MPR.

Respondents' views

3.7. The vast majority of respondents considered that the respective code panels should make filtering decisions, with Ofgem having the power to override a decision. Some respondents expressed the view that Ofgem's power to override decisions should be time-limited, whereas others believed that Ofgem should continue to have that power throughout the process.

3.8. Several respondents suggested that Ofgem decisions to override a code panel's filtering decision should be appealable, for example by Consumer Focus. Some respondents considered that a right of appeal should only be introduced for modifications being moved from self-governance to the *status quo* path, or from the *status quo* path to a major policy review, but not in the other direction.

3.9. It was pointed out that it would not always be straightforward to make filtering assessments at the outset of the modification process. It was also noted that the time taken to conduct such analysis would increase the length of the overall process.

Ofgem's initial proposal

3.10. We agree with the majority of respondents that filtering decisions should be made by the relevant code panel but that Ofgem should be able to override such decisions if it becomes clear that a proposal was not suitable for self-governance.

3.11. We propose that code panels should consider whether a code modification proposal should follow Path 2 or 3. We do not propose that code panels should consider whether a proposal should trigger an MPR. However, interested parties of course may make representations to that effect. In addition, we propose that Ofgem should be able to indicate that a modification proposal should trigger a (or be taken account of in an existing) MPR. This is discussed further in Chapter 4.

3.12. We believe that the Ofgem power to override filtering decisions should remain available until such time as a decision is made on the modification proposal by the industry. Naturally, where we are exercising this power, we would hope to do so at an early stage of the modification process. However, we cannot rule out that relevant information comes to us at a late stage that would lead us to redirect a proposal to another development path. We believe that introducing this flexibility would better enable us to protect consumers' interests.

3.13. We invite views on these aspects of the filtering process.

Filtering Criteria

3.14. In December 2008 we proposed the following criteria for making filtering decisions for the Path 1 and Path 2 processes.

Path 1 - Filtering criteria

3.15. In December 2008 we set out some criteria which, if one or more were met, could result in Ofgem subsuming a modification proposal within a Path 1 MPR.[3] The proposed Path 1 criteria were as follows:

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 modification 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

[3] Ofgem would have a right but not an obligation to instigate a Major Policy Review.

raises an issue that could require changes to more than one code, licences or to charging arrangements; and/or

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 would significantly engage our wider statutory duties (e.g. environment, sustainable development[4] or security of supply), we may send the modification to Path 1.

Path 2 - Filtering criteria

3.16. We outlined several criteria that could be applied to determine whether a modification would be sent to Path 2. We suggested that if a modification met none of these criteria it would be sent to Path 3. We noted that the criteria were similar to those applied under DCUSA to assess whether modifications should follow a self-governance route. The criteria were as follows:

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; and/or,
5. the modification impacts on the code change process or proposed other material code governance changes.

3.17. In December 2008 we noted the possibility that a modification proposal might be sent to Path 3 but that an alternative proposal could be raised during the course of the assessment which, if it had been proposed originally, would have gone to Path 2.

3.18. We suggested that the Path 2 filter should be re-applied to any such alternative proposals. We also observed that, ideally, all such related modifications should be treated under the same path to ensure that they are treated consistently and through the same process.

[4] In June 2008 Ofgem issued guidance on to the treatment of greenhouse gas emissions (GHG emissions) under the existing code objectives. The guidance noted that industry and relevant code panels were free 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.

Respondents' views

3.19. Most respondents considered that the criteria needed to be more detailed to reduce the scope for subjectivity or creative interpretation. On the other hand, some respondents (such as the Joint Office, administrators of the Uniform Network Code) took the view that the suggested criteria were sufficiently flexible to allow the exercise of sensible discretion and observed that any additional clarity that may be required could be provided in the form of guidance on interpretation of the criteria.

3.20. Elexon, the administrators of the Balancing and Settlement Code (BSC), noted that the suggested criteria created a misalignment with the BSC Objectives since there were no requirements within the BSC Objectives (and equally within any of the other code objectives) to consider the impacts a modification has on consumers.

3.21. One respondent provided some alternative criteria based on how well the modification was worked up, material objections being raised to the modification proposal progressing down the self-governance path or the impacts a modification had on other codes, licences or modifications going through the process.

Ofgem's initial proposal

3.22. Ofgem considers that the criteria on which we consulted in December 2008 represent a reasonable basis for determining whether or not a code modification proposal is likely to trigger an MPR.

Path 1 - Major Policy Review

3.23. We propose that Ofgem should have the ability to initiate an MPR where a modification proposal exhibits one or more of the following characteristics:

- the proposal is likely to have **significant impacts on competition or on gas and electricity consumers** (this may be based on a qualitative assessment since the idea is to streamline the process and not to add another stage to it);
- 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, licence or set of charging arrangements; and/or
- the proposal is likely to have **significant impacts on the environment, sustainable development or security of supply**.

3.24. We believe that we should also have the ability to initiate an MPR in response to Government policy decisions or unforeseen circumstances that appear to Ofgem to require us to consider the case for major policy reform.

3.25. We welcome views on the factors that Ofgem should consider in deciding whether a modification proposal might warrant an MPR.

Path 2 - Improved status quo

3.26. We propose that the code panel should be required to direct a modification proposal to the Path 2 process if, in the opinion of the code panel, it exhibits one or more of the following characteristics:

- it is likely to have non-trivial impacts on competition;
- it is likely to have non-trivial impacts on sustainable development;
- it is likely to have non-trivial impacts on the operation of the relevant gas or electricity system;
- it is likely to discriminate in its effects between classes of users;
- it is directly related to safety or security of supply or relates to the management of market or network emergencies; and/or
- it is likely to have non-trivial impacts on consumers.

3.27. We also consider that, where modification proposals have a non-trivial impact on the code change process or on other proposed material code governance changes, those modifications should follow Path 2 rather than self-governance.

3.28. In order to prevent modifications that have very minor impacts on matters that fall within Ofgem's statutory duties, such as competition or consumers from coming to Ofgem for a decision, we have included the term "non-trivial" in the criteria for modifications that should be assessed under Path 2.

3.29. On reflection, we believe that the characteristics set out in the December 2008 document did not capture effects on sustainable development. We have amended the list accordingly. We also consider that the list did not reflect existing code objectives relating to efficient system operation. We therefore believe that one of the characteristics, for the network-related codes, should relate to system operation.

3.30. These characteristics are similar to those applied under DCUSA to assess whether modifications should follow a self-governance route. We propose that if, in the relevant panel's view, a modification proposal exhibits at least one of these characteristics, the proposal should enter Path 2 leading to a decision by Ofgem.

3.31. The DCUSA sets out that certain matters are for Ofgem to make the decision. Given the proposed introduction of a set of filtering criteria, we do not believe that it is necessary for codes such as DCUSA to identify separately lists of matters that fall within self-governance from those that require decisions from Ofgem. The development of categorisation processes and lists of this nature across all of the industry codes would represent a substantial exercise and potentially reduces flexibility in the filtering process. We therefore consider that such an approach is not necessary and for those codes that adopt a separate categorisation framework (such as DCUSA), we would welcome views on whether existing categorisations should be removed.

3.32. We recognise that the code objectives are not based around consumers. However, we consider that it should be possible for code panels to provide an opinion on consumer impacts, seeking input and advice as necessary from Consumer Focus.

3.33. We welcome views on the proposed criteria for Path 2 modifications.

Modifications within the scope of an existing MPR

3.34. In December 2008 we noted the possibility that a modification might be raised that falls within the scope of an existing MPR that has already been initiated by Ofgem. We suggested that in those circumstances there should be a moratorium on raising code modifications on issues that are the subject of MPRs.

3.35. We stated that, under such an approach, the Authority could designate that a modification that has been raised falls within the scope of a Path 1 review. The Authority would then formally reject the modification but have the ability to take account of the ideas contained in the proposals as part of the MPR process. We noted that this would give a clear signal to market participants that modifications on MPR areas should not be raised during the course of an MPR.

Respondents' views

3.36. A majority of respondents considered there should be no moratorium on modifications that interacted with an existing MPR. They were concerned that our proposals lacked the flexibility to deal with potentially unforeseen urgent issues that might arise in relation to matters that are the subject of an MPR. Some of these respondents suggested that the progress of such modifications should be at the discretion of Ofgem/the Panel. Conversely, others considered that modifications which overlapped with an MPR should either be frozen or subsumed within the MPR.

Ofgem's initial proposal

3.37. Where a non-urgent modification proposal is raised that Ofgem considers is within the scope of an MPR, we propose that it should not proceed through the industry consultation process but rather should be subsumed within the MPR. This would enable Ofgem to take on board any ideas contained in the non-urgent modification that it thinks fit.[5] Interested parties would be free to make representations to that effect. We believe that this would enable Ofgem to take full account of new ideas and evidence presented by code participants in reaching our MPR conclusions.

[5] We are, however, proposing that a 'time window' be introduced for code parties (and relevant consumer representatives) to raise code modification proposals following the completion of an MPR and the issuing of any Ofgem directions on licensees to raise proposals. This is discussed further in chapter 4.

3.38. If, at the end of the MPR, Ofgem concludes that no directions are necessary, we propose that new modification proposals raised thereafter should follow the usual industry consultation process.

3.39. We agree with respondents that it is possible that urgent issues might arise whilst an MPR is underway and that flexibility is needed to deal with this. We therefore propose that code parties (including relevant consumer representatives) should retain the right at any time to make representations to raise an urgent modification proposal to modify existing code arrangements. However, it would remain open to Ofgem to turn down such requests, in which case the modification proposal would not proceed to consultation or decision. Any urgent modifications that Ofgem allows to be raised would follow existing governance processes.

3.40. We invite views on the proposed treatment of urgent and non-urgent modifications during the MPR.

Mechanisms to re-direct modification proposals

3.41. In December 2008 we stated that there was a risk that consumer or competition issues might become apparent after a modification proposal had entered the self-governance process. We said we would consider introducing a mechanism to enable such modifications to be sent to Path 2 for a decision ultimately by Ofgem.

Respondents' views

3.42. Most respondents agreed that there should be a mechanism for redirecting self-governance modification proposals into Path 2 if, at any stage before a decision is taken, it becomes clear that they would be likely to have non-trivial impacts on consumers or competition. They considered that industry participants should be able to request that Ofgem redirects such proposals into Path 2.

Ofgem's initial proposal

3.43. We agree with respondents that all code parties and consumer representatives should be able to request to Ofgem that a self-governance modification be sent into Path 2 if they consider that the proposal meets the relevant criteria, for example, if it would be likely to have a material impact on competition or consumers. We propose that it would be open to Ofgem to accept this request or alternatively to confirm that the code panel's original filtering decision was correct.

3.44. We also propose that Ofgem should be able to redirect modifications into self-governance if we do not agree with a panel's filtering decision. In the case of modifications that are re-directed into Path 2, we propose that Ofgem should be able to make these decisions right up to the point at which a self-governance code modification decision is made. As we are already proposing to introduce a power for Ofgem to override panel filtering decisions, we do not propose any other formal mechanisms to send proposals back to Path 2. We also consider that code panels (or

the relevant self-governance decision-maker) should be placed under an obligation to inform Ofgem if it becomes clear that a self-governance modification may meet the relevant criteria for Path 2. We believe that these provisions would represent a key protection for consumers in the event that a self-governance modification had non-trivial consumer or competition impacts.

Back-casting exercise

3.45. In December 2008 we published the results of a 'back-casting' exercise assessing how often each Path might have been used if they had been available for all of the modification proposals raised over the previous 12 months. We concluded that an MPR 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. We stated that electricity cash-out and transmission access reform were two examples of the kinds of policy area that would trigger the Path 1 process. Looking forward, smart metering could well be another.

3.46. Some respondents to our December 2008 consultation suggested that we might have overstated the proportion of proposals that would go to self-governance. Even if this turns out to be case, we still believe that it is a worthwhile reform to pursue. Experience with existing self-governance arrangements suggests that, once industry participants become familiar with the arrangements and panels are confident in operating the rules, they could be used for an increasing number of modification proposals.

4. Proposed "Major Policy Review" process

Chapter Summary

This chapter sets out the process for undertaking MPRs, what form the outcome of the MPR would take and the safeguards for interested parties. We propose that the MPR process should be able to adapt according to the issues under review but that in all instances it would be highly consultative.

We consider it important that our proposals should not in any way circumscribe the ability of code panels to vote on MPR-related modifications (consistent with their responsibilities as code panellists) and for interested parties to seek to appeal our subsequent decisions. We consider that our proposals would not do this. Nor do we consider that our proposals could circumscribe the power of the Competition Commission to review our code modification decisions.

Question box

Question 1: Do you agree that Ofgem should retain the flexibility to vary the MPR process according to the complexity of the issues involved?

Question 2: What are your views on the options for determining the outcome of an MPR?

Question 3: Do you agree that the industry should be given the responsibility of drafting appropriate MPR-related code modifications, with Ofgem having a power to draft them only if the industry fails to do so within a specified time period?

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

Question 5: Do you support our proposal for a time-window in which subsequent code modifications could be proposed after the completion of an MPR?

Question 6: Do you agree that Ofgem should be able to revise its MPR conclusions in the light of subsequent new information?

Major Policy Reviews

4.1. In December 2008 we noted that the introduction of an MPR 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. We believe that this is a proportionate rebalancing of powers that would better enable the sector to meet the challenges of climate change and security of supply.

4.2. In this chapter we summarise the responses to our December 2008 consultation and set out our initial proposals for how the MPR process should operate.

Process for MPRs

4.3. We consulted on the basis that an MPR could be initiated where Ofgem identifies a significant policy issue that appears to have implications for an industry code; in response to Government-led public policy initiatives; or after an industry participant has raised a code modification proposal within a key strategic area. In all instances the decision to carry out an MPR would be for Ofgem.

4.4. We suggested that, in the case of an MPR that has been triggered by a code modification, the triggering modification should be formally rejected at the start of the MPR process. However, we stated that the ideas in the proposal could be considered as part of the MPR process and could form the basis for drafting implementing modifications at the conclusion of the MPR.

4.5. We noted that MPRs must be undertaken on a proportionate basis. We stated that MPRs should only be used in limited circumstances where there are significant policy issues present. Based on past experience, we expected that we would not initiate more than one or two such reviews in a financial year.

4.6. We expressed the view that licence modifications would be needed in order to enable the implementation of the MPR process. We stated that the licences should create an overarching framework under which an MPR would occur, with the possible result that licence holders would be required to raise a modification proposal to address the concerns identified through an MPR process.

4.7. In December 2008 we stated that imposing a uniform MPR process would be inflexible, as the level of consultation undertaken might potentially differ depending on the nature of the issues involved. We suggested that an MPR on an issue such as electricity transmission access might require multiple consultations, and industry workshops, but that an MPR on an issue such as trade and transfer of gas entry capacity rights might require fewer consultations. We concluded that the MPR process should be proportionate to the subject and scope of the review.

Respondents' views

4.8. Several respondents stated that they wanted more details on the structure of the MPR process. Though some respondents acknowledged that there needed to be a degree of flexibility as to the exact process an MPR would follow, they would like to see as a minimum some high level procedures that all MPRs should follow.

4.9. A few respondents considered that for MPRs Ofgem should introduce more innovative and smarter ways of engaging with industry. They suggested the use of roundtable discussions, 'teach-ins', more accessible documents and meeting directly with stakeholders. One party argued that there would be a considerable loss of transparency within an MPR process compared with the current industry-led process.

4.10. Several respondents were concerned that unless Ofgem committed to a strict timetable the MPR process would not deliver its intended benefits in terms of efficient decision-making.

Ofgem's initial proposal

4.11. We propose that MPRs could be triggered in the following ways:

- where Ofgem identifies a significant policy issue that appears to have implications for an industry code;
- in response to Government-led public policy initiatives;
- after an industry participant has raised a code modification proposal within a key strategic area (as stated in chapter 3, such modifications would not proceed through the modification process but would be subsumed within the MPR thereby enabling the ideas contained in it to be considered as part of the MPR process).

4.12. We would seek to give as much prior notice as possible of our intention to undertake an MPR. For example, where reasonably possible we would aim to indicate in our Corporate Strategy and Plan any intention to conduct an MPR in the forthcoming financial year and to set out a proposed timetable for delivery. Interested parties would be free to make representations as part of our planning process that an issue should be dealt with through the MPR process. It would also be open to interested parties to argue that a code modification gives rise to such issues. The decision to undertake an MPR would, however, reside with Ofgem.

4.13. We do not propose to commit to a single process that would apply rigidly to all the MPRs that we undertake. Rather, we would prefer to retain the scope to modify the process according to the complexity or contentiousness of the issues at stake. We do however propose to consult thoroughly during the MPR process. We would in particular seek views on the scope of the MPR, the issues to be considered and the options for reform. We would also expect to undertake a full impact assessment on our proposals before issuing any directions. We would also seek opportunities to supplement written consultations with stakeholder events such as workshops and roundtable conferences. We undertake to give stakeholders ample opportunity to influence the policy process before we reach any conclusions. We would also, at the outset of an MPR, set out clearly the proposed timetable.

4.14. We believe that by conducting a single, holistic consultative process on a major policy issue, we would achieve an increase in transparency relative to the existing codes process, which is complex and piecemeal by nature and, indeed, difficult for many participants to engage in (particularly small parties).

4.15. As indicated in our December 2008 document, we expect to conduct not more than one or two MPRs in a financial year.

4.16. We welcome views on this aspect of our proposals.

Outcome of MPRs

4.17. We consulted on the basis that the outcome of the MPR must make clear what changes are needed to industry codes (and possibly to other documents). We put forward three options for determining the outcome of an MPR.

4.18. Under option 1, Ofgem would carry out the review and develop **high level policy conclusions**. Ofgem would issue a direction to relevant licence holders to raise a modification proposal(s) that would deliver the conclusions of the review. Under option 2, Ofgem would carry out the review and develop **detailed conclusions** that could take the form of an 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 and the code panel/relevant licence holder(s) would be required to develop a modification proposal based on the binding outline. Under option3, Ofgem would carry out the review and **draft the modification proposal(s)** necessary to implement the conclusions, **including the legal text**.

Respondents' views

4.19. Views were mixed on the level of detail that our MPR conclusions should take. Slightly more respondents preferred high level or detailed conclusions (options 1 and 2) compared to Ofgem drafting the modification and legal text (option 3). Concerns were, however, expressed about each of the options.

4.20. There was widespread concern that the MPR process would effectively mean that Ofgem would be acting as 'judge and jury' in its own cause, which was contrary to better regulation principles. Most respondents thought that this would be especially problematic if Ofgem had actually drafted the modification proposals, as was envisaged under option 3. It was suggested that Ofgem could be the originator, work-flow manager, prosecutor and decision-maker as part of the MPR process. Conversely, a couple of respondents argued that option 3 at least had the merit of explicitly recognising that Ofgem was the source of a code modification proposal.

4.21. Some respondents argued that high level conclusions were not always easily transferable into practical working solutions. At the same time, many considered that Ofgem did not have the relevant expertise to draft the requisite legal text for codes; rather, the expertise lay within industry.

Ofgem's initial proposals

4.22. We propose that the MPR process would lead to Ofgem publishing its policy conclusions. The conclusions document may also set out the policy arrangements that would need to be reflected in the codes (and possibly in other documents).

4.23. We have set out in chapter 2 why we do not believe that Ofgem would be acting as "judge and jury" under the MPR process. We have also considered further the options on which we consulted in December 2008 in the light of respondents'

views. In doing so, we have taken full account of the Competition Commission's view, set out in the E.ON/GEMA/British Gas Trading Ltd appeal, that "if GEMA is the effective progenitor of a proposal, there may be a perception that it cannot fulfil its intended role under the...modification procedures without having prejudiced, or at least appeared to prejudice the matter".[6]

4.24. It is important to note that the Competition Commission also stated that, given the possibility of appeals to it under the Energy Act 2004, "the problem we perceive is less acute than it once was". The Competition Commission also noted that the argument that the Authority "should never seek to influence the content of code modification proposals…would face some difficulty". Finally, the Competition Commission concluded that natural justice would not be offended if Ofgem is the "effective progenitor", provided that "where GEMA is giving or refusing its consent to [such] proposals, [its] better regulation duties of transparency and accountability apply with particular rigour"[7].

4.25. Given these important considerations, and in the light of our determination to run a consultative MPR process and to evaluate in an open-minded way any subsequent modification proposals that come to the Authority for a decision, we do not believe that any of the options could be ruled out on better regulation or any other grounds. That said, within a policy framework determined by Ofgem, we would prefer to draw on the industry's own expertise in drafting and considering code modifications.

4.26. We are therefore proposing to take forward option 1 and option 2, which involve Ofgem setting down the principles that should inform any code modification proposal and perhaps outlining the code modification proposal itself. In practical terms, we envisage that Ofgem would assess on a case-by-case basis whether to set out high level or detailed principles only. In some cases it may be appropriate to include an outline code modification.

4.27. We also propose that Ofgem should have a 'backstop' power to draft code modifications in the event that the original modification is not being progressed within the appropriate timescales or does not reflect Ofgem's policy conclusions.

4.28. We welcome views on which of the options we should pursue and in particular whether Ofgem should have a power to draft modification proposals if licensees do not develop appropriate modifications in a timely manner.

[6] Case reference CC02/07, July 2007 determination on UNC116V and UNC116A, paragraph 6.192.
[7] CC02/07, paragraphs 6.193 and 6.196.

Implementing the outcome of MPRs

4.29. In December 2008 we noted that the process for implementing the outcome of the MPR would depend on the option chosen for the format of the conclusions of the review process discussed in the preceding section. Under options 1 and 2, the policy conclusions would be passed to industry to develop detailed modification proposals. We expect that under this approach the modification proposals would then be assessed by the industry in the normal way.

4.30. In the event that Ofgem has a fallback power to draft modifications, Ofgem could draft a detailed modification proposal or proposals, including drafting of the modification to the code itself. This would then enter the industry consultation process before passing to the relevant code panel for assessment.

4.31. In order to implement options 1 and 2, a licence obligation could be introduced requiring the relevant licence holder to comply with a direction from the Authority arising out of an MPR. This could take the form of a direction to the licence holder to raise a modification proposal or proposals.

Respondents' views

4.32. Many respondents considered that our MPR conclusions should not be legally binding. There was concern that if the requirement to implement legally binding conclusions were written into code objective this would restrict the ability of code parties to vote on MPR-related modifications.

4.33. Respondents also felt that, if Ofgem's MPR conclusions were legally binding, it would place too much emphasis on the views of one organisation and would also lead to more appeals either to the Competition Commission or by judicial review. Others noted that, if industry did not raise proposals after the publication of our MPR conclusions, it would indicate little or no support for our conclusions.

Ofgem's initial proposal

4.34. We consider that the relevant licence holder should have an obligation to raise and facilitate consultation on modifications that give practical effect to any MPR-related directions issued by the Authority. This obligation, which would be generic in form rather than focussed on specific policy areas, could be introduced through a licence modification. Under this approach, licensees would be obliged within a specified period of time, via a direction issued by the Authority, to develop and consult on modifications that give practical effect to the matters set out in the direction.

4.35. We propose that the time period specified for the development of the modification proposal(s) should be assessed on a case-by-case basis and that the Authority should therefore have the discretion to vary the time period according to the number and complexity of modification proposals that need to be produced.

4.36. Under options 1 and 2 the relevant licence holder would raise the code modification proposal and the relevant code panel would make recommendations on the proposal. Given that any modification proposals should reflect any directions issued following an MPR we are not proposing that they proceed through the proposed filtering process. Instead, the modification(s) would all come to the Authority for decision.

4.37. As discussed above, we are proposing that Ofgem should have backstop powers to draft the modification itself, if the original modification is not being progressed within the appropriate timescales or does not reflect Ofgem's policy conclusions. If so, Ofgem would be vested with the power to raise the code modification, which would then proceed to industry consultation in the usual way.

4.38. We do not consider that there should be a new code objective governing the implementation and discharge of Authority directions following an MPR. This is because such an objective would potentially prevent code panels and licensees from voting against a modification proposal that the Authority has directed to be raised. Code parties should retain the right to vote and make recommendations on such modifications as they see fit (consistent with their responsibilities as code panellists). Parties' rights to appeal MPR based modifications to the Competition Commission could not therefore be frustrated by restrictions on panel voting.

4.39. We would welcome views on these elements of the proposals.

Appeal mechanisms

4.40. In December 2008 we noted that, regardless of whether option 1, 2 or 3 was followed, Ofgem's eventual decisions on MPR-related code modification decisions were capable of appeal to the Competition Commission under the existing Energy Act 2004 framework[8]. We also noted that such an appeal would be available only once the Authority had reached its final decision and only in circumstances where that decision was against the recommendation of the relevant code panel.

4.41. We took the view that because the existing statutory framework provided for a full merits appeal, there was no need to create any new appeal rights. We recognised too that industry participants could also seek judicial review of any decision made by Ofgem following an MPR. We stated that the creation of additional appeal rights to the Competition Commission, for example at the end of the MPR process, would be disproportionate given that an effective appeal right already existed in relation to code modification decisions. In addition, we noted that the

[8] SI 2005 No 1646 The Electricity and Gas Appeals (Designation and Exclusion) Order 2005: http://www.opsi.gov.uk/si/si2005/20051646.htm.
SI 2009 No 648 The Electricity and Gas Appeals (Designation and Exclusion) Order 2009: http://www.opsi.gov.uk/si/si2009/uksi_20090648_en_1.

creation of new appeal rights would require changes to legislation, which could only be made by the Secretary of State.

Respondents' views

4.42. Many respondents questioned the impact of an MPR process on the existing Energy Act appeals arrangements. Concern was expressed that if a licensee was to raise modifications to implement legally binding conclusions, this would affect its ability to contest such a modification and potentially appeal such a modification.

4.43. Some respondents also considered that any form of legally binding conclusions would prevent the industry from raising a full merits based appeal to the Competition Commission on the basis that the Competition Commission would have to consider any appealed modifications within the confines of such legally binding conclusions.

4.44. Some respondents suggested that this drawback could be overcome by creating a right of appeal immediately after legally binding conclusions were issued. Others noted that they would like more certainty about the applicability of the existing appeal arrangements by way of transparent opinions from the Competition Commission and/or eminent legal counsel.

Ofgem's initial proposal

4.45. Many respondents were concerned that the idea of 'legally binding directions' would restrict the ability of code parties to seek to appeal Ofgem's MPR-related code modification decisions. For the avoidance of doubt, we propose that the licence holder would be required by means of a licence condition to comply with a direction issued by Ofgem. Such a direction would require the licence holder to develop and formally raise within an appropriate period of time one or more code modifications that reflect any MPR-related directions issued by Ofgem (which might vary according to the number of code modifications and their complexity). At this point, we propose that the licence holder would have discharged its obligations under the licence.

4.46. We recognise that there is nonetheless a perception amongst respondents that Ofgem would not be sufficiently accountable under the proposed arrangements. As stated in chapter 2 above, we do not consider that this is a fair representation of the MPR process and of our role within it.

4.47. We have already set out our intention to run a highly consultative MPR process. In addition, once Ofgem has issued directions on relevant parties to raise modification proposals, there would be further consultation with code participants on these proposals. Thus the process of consultation would not end with the completion of the MPR but would instead continue until decisions are taken by the Authority on the relevant modification proposals.

4.48. We continue to consider that there is no need to introduce new appeal rights to the Competition Commission at the conclusion of the MPR process. This is because

the conclusion of the MPR would merely be the start of a process of further consultation on code modifications which the industry would be required to work up. We note that the existing mechanisms for seeking judicial review could apply to decisions taken by Ofgem during the MPR process. In addition, once the Authority had reached a decision on the relevant modification proposal, parties would be able to seek an appeal at the Competition Commission where it considered it had grounds to do so and the criteria were met.

4.49. We have also considered whether, in considering an appeal, the Competition Commission could be restricted in its ability to undertake a review of the code modification decision by the MPR process. We do not consider that the MPR could in any way circumscribe the legal right of the Competition Commission to address any matters that it considers relevant to the case before it. Indeed, to the extent that the modification reflected the conclusions of an MPR process, the Competition Commission would be able to evaluate Ofgem's MPR conclusions as part of the appeal. We would also note that the power of the Competition Commission to determine an appeal is derived from the Energy Act 2004 and the statutory instruments governing the appeals process and it is not possible for the Authority to alter these powers in any way.

4.50. As stated in chapter 2, we have held discussions with the Competition Commission about our MPR proposals. The Competition Commission noted that our proposals would not affect code participants' rights of appeal against our code modification decisions under Energy Act and did not anticipate that the proposals, if implemented, would affect the manner in which the Competition Commission conducts any such appeals.

4.51. Given the scope for appeal within the proposed arrangements we do not consider that it would be proportionate to introduce a further right of appeal for industry participants or other interested parties at the completion of the MPR stage and before the detail of the code modification proposals has been worked up and consulted upon as part of the code modification process. We consider that this is very similar to the process that is in force in respect of licence modifications, in that Ofgem consults on key issues and options before proceeding to consult on and initiate formal licence changes. Under these processes, the possibility of a reference to the Competition Commission for determination does not arise until such time as Ofgem seeks to formally amend the licences of the relevant licence holders and not at an earlier stage.

Moratorium on subsequent modification proposals

4.52. In December 2008 we sought views on whether, in order to maximise the efficiency benefits of the Path 1 process, Ofgem should be able to postpone consideration of a modification proposal if it related to issues that had been addressed in an MPR in the previous two years. We also invited views on whether a complete moratorium should be placed on the raising of code modification proposals on issues that were covered in the MPR.

4.53. We noted that such a moratorium might prevent the re-opening of issues that have just been decided upon and might therefore promote certainty. We acknowledged the significant risk that a moratorium might unnecessarily prevent incremental improvements being made to a recently introduced framework. We further recognised that when significant reforms are introduced, there are often some problems and issues that arise and which need to be addressed.

4.54. We consulted on an alternative approach of allowing modifications to be raised after an MPR at the discretion of Ofgem or subject to an Ofgem veto. If this option were implemented, Ofgem could then permit a modification to proceed so long as it was not seeking to re-open issues addressed in the MPR.

Respondents' views

4.55. Many respondents expressed the view that the industry should be able to raise modifications related to issues that have recently been the subject of an MPR. Respondents argued that new information or evidence might come to light that would have had a bearing on our MPR conclusions and that industry participants should have the ability to propose further changes as a result. Some industry participants pointed out that a moratorium might prevent necessary or urgent changes to the existing arrangements from being developed. Respondents noted that Ofgem would still have the power to reject any such modifications that arose.

Ofgem's initial proposals

4.56. We agree with respondents that the governance framework should retain the ability to respond efficiently to changing circumstances even in areas that have recently been the subject of an MPR. We also recognise that industry participants and code parties may wish to progress their own related proposals to those which have been developed via an Ofgem direction. We have been considering how to reflect these aspirations with a view to increasing the flexibility and responsiveness of our MPR proposals.

4.57. We therefore propose that the MPR framework provides parties with a "time window" in which to raise alternative modification proposals to those which Ofgem has directed licensees to raise. This would help to ensure that if industry participants have strong preferences for alternative models these can be progressed by industry and decided upon by the Authority. Where these competing or alternative modifications have been progressed, any subsequent modification decision would also be appealable to the Competition Commission where the criteria are met.

4.58. We believe that the use of a "time-window" should avoid the possibility of piecemeal modification proposals being raised over a period of many weeks and months. It would also ensure that the assessment of all the modifications relevant to the MPR could be undertaken as a single process without being unnecessarily delayed. The "time window" could, for example, be set for a period of two months from the Authority's completion of an MPR. This would allow industry participants to

bring forward in a timely manner alternative proposals that might not have been fully explored during an MPR.

4.59. We are also proposing that Ofgem has the power to turn down the consideration of alternative proposals raised within the "time window" if they are insufficiently developed. We envisage that while this would still enable parties to raise legitimate alternative proposals, Ofgem would be able to prevent parties from stalling the modification process by raising spurious or undeveloped proposals. We welcome views on whether such a power should be available to Ofgem.

4.60. We also consider that the Authority should have the ability, where necessary, to revise its policy or reconsider its MPR conclusions and issue new directions, for example, as policy detail develops or if new information comes to light that has a bearing on them.

4.61. On reflection, we do not propose to restrict the ability of code participants to propose new modifications after an MPR-related modification has been implemented. Indeed, we recognise that following any major policy reform process it might be necessary to make incremental improvements or adjustments. However, given that code participants could raise urgent modification proposals at any stage (to change existing code arrangements) and could raise non-urgent alternative modifications during the time window, we propose that parties should not be able to raise further non-urgent modifications in the period between the Authority making a decision on a modification and its implementation.

4.62. We propose that if a modification decision is appealed to the Competition Commission, no new modifications should be raised for the duration of the appeal process. If the Competition Commission upholds an Authority decision to approve a modification, remits a decision back to the Authority for further consideration, or directs that a different modification be made, we propose that no further modifications should be raised until a modification within the scope of the MPR has been implemented. We welcome views on this.

4.63. We welcome views on whether it would be sensible to introduce a time window for new modifications (with or without an Ofgem veto) and to enable Ofgem to re-consider its MPR conclusions and issue new MPR directions in the light of new information.

5. Self-governance

Chapter Summary

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: Do you agree that the industry should draw up proposals for panel and voting arrangements and submit them as part of a self-governance package to Ofgem for approval?

Question 2: Do you agree that there should be general appeal rights equally applicable to all code participants? Do you agree with the proposed appeal grounds?

Question 3: Do you agree that Ofgem should hear appeals of self-governance modification decisions? Do you support the proposals in respect of interim forums, time limits and frivolous or vexatious appeals?

Self-governance process

5.1. The final key element of the proposed package of reforms is the self-governance process that should apply for modification proposals following this path.

5.2. We noted in December 2008 that a key concern was to ensure that the self-governance regime conforms to the Review's objectives and has effective safeguards, particularly for small market participants and consumer representatives.

5.3. We also recognised that there were likely to be alternative ways to introduce self-governance and that industry code signatories would be free to take a leading role in developing their own procedures, subject to certain safeguards being present. In developing suitable self-governance arrangements, we noted that it would be important to recognise that each of the codes has evolved differently with varying panel structures and decision-making arrangements. Whilst there may be benefits in seeking to harmonise these arrangements, we did not consider that harmonisation was a necessary pre-requisite to establishing self-governance.

5.4. We stated that the design of the self-governance process needed to address four main questions, which were as follows:

- who should be the decision-maker for the modification proposal?
- what voting procedures should apply governing decisions?
- should there be mechanisms to send proposals from Path 3 to Path 2 and vice versa?
- what appeal rights should exist?

Who makes the decision on the code modification?

5.5. In December 2008 we sought views on whether decisions should be made by an independent panel, a representative panel or by all code signatories. We made clear that a key issue for Ofgem in determining the arrangements would be to ensure that the interests of small market participants and consumers are protected. To that end, we expressed an initial view that there ought to be consumer and small participant representatives on any panel (whether independent or representative).

Respondents' views

5.6. A slight majority of respondents expressed a preference for representative panels, although many considered that the existing panel arrangements on the respective codes were appropriate for each code.

5.7. There was a mixed response to the question of mandatory representation for consumers and small participants. Many respondents commented that such a mandatory right was not necessary; some noted that in the Uniform Network Code this would effectively give such representatives a casting vote. Others noted that it was vital to ensure that all interests were fairly represented on the code panels. These respondents argued that this was the best means of ensuring that a self-governance process would not be dominated by the large incumbents and that smaller parties would be able to influence decisions.

Ofgem's initial proposals

5.8. Ofgem does not have a particular preference for one type of panel over another. We are therefore content for the industry to develop this aspect of the self-governance regime themselves and submit proposals to us for approval. However, we remain of the view that any panel structure should include consumer representatives and that these parties should have voting rights. In deciding whether or not to approve any proposals that provide for changes in panel structures, Ofgem would have regard to the extent to which the panel arrangements provide for adequate representation of consumer interests.

5.9. We have today consulted on initial proposals relating to the role of code administrators. In that document we express the view that creating dedicated panel seats with voting rights would not be the most effective means of delivering significant benefit to smaller participants. We consider that the resource implications required to fulfil such a role would be counter-productive to our aim of allowing smaller parties to gain maximum value from their potentially limited engagement in the process, particularly as not all proposals will directly impact smaller participants.

5.10. Instead, we have outlined proposals to require code administrators to engage smaller participants proactively where a proposal has a direct relevance to them, rather than relying on the more usual blanket communication methods.

Forms of voting

5.11. In the December 2008 document we noted that decisions could be taken by simple majority or by super-majority of votes cast and that votes could be weighted by some metric of size, such as customer numbers. We expressed the view that if there were signatory voting it might be necessary to specify rules on minimum number of votes (or even to make voting mandatory). We noted that without such a rule decisions could be made by a small number of industry participants. However, we acknowledged that this might be less of an issue if there were an appeals process. We also noted that 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.

Respondents' views

5.12. Most respondents considered that the panels should make the final decisions on self-governance modifications, rather than all code signatories. There was a general preference for simple majority voting, though some smaller industry participants felt that super-majority voting would better protect their interests.

Ofgem's initial proposal

5.13. As with the issue of the constitution of the panel, we do not have a strong preference in terms of the voting mechanisms that might be adopted. We are content for the industry to develop this aspect of the self-governance regime and submit proposals to us for approval.

Mechanisms to redirect modifications between Paths 2 and 3

5.14. As set out in chapter 3, we propose that Ofgem should be able, right up to the point at which a code modification decision is made, to redirect proposals from Path 3 to Path 2 or vice versa. We also propose that code panels or the relevant decision-maker should be obliged to inform Ofgem if it becomes clear that a code modification proposal is not suitable for self-governance. We believe that these provisions would provide valuable safeguards for consumers if a self-governance system were to be introduced.

Appeals process

5.15. In December 2008 we expressed the view that the appeals process would be a vital part of the self-governance process, particularly given the difficulties that small market participants and consumers (or their representatives) often face in engaging in codes processes. We noted that the nature of the appeals process might depend in part on the voting structures adopted for decisions on code modifications.

5.16. We stated that we expected industry participants to take a leading role in defining an appropriate appeal structure. We also consulted on the issue of whether consumer groups and small market participants should have specific rights of appeal, particularly given the possibility that the Big Six suppliers might dominate the self-governance process.

5.17. We expressed an initial view that there should be automatic rights of appeal for Consumer Focus and/or small participant representatives over industry decisions on self-governance modifications. We noted that such appeal rights could be embedded within the code modification rules for the relevant code. We also stated that if an appeal was unsuccessful then the party raising the appeal should bear the costs.

5.18. We also consulted on who the appellant body should be. We noted that Ofgem was a natural candidate to manage an appeals process. However, we also stated that an independent arbitrator could potentially be appointed to hear appeals given that any appeals were likely to relate to commercial issues with little impact on competition or consumers.

Respondents' views

5.19. Nearly all respondents considered that there should be a general right of appeal for all parties (including consumer groups) against self-governance modification decisions. There was little support for the idea of special appeals rights for consumer groups or small participants; Consumer Focus itself signalled that a general right of appeal for consumers was not necessary. Consumer Focus (and some others) did state that there should be a requirement to show some form of disproportionate impact on a party or class of party before an appeal could be heard.

5.20. Most respondents who commented considered that Ofgem should be the body that hears appeals for self-governance modification decisions. Several argued that the existing right of appeal to the Competition Commission should also be available at the end of the self-governance process.

Ofgem's initial proposals

5.21. In line with the views of respondents, we propose that there should be a general right of appeal for all parties against self-governance modification decisions. We do not propose to create special appeal rights for consumer groups or small industry participants. We propose that the grounds for appeal should be limited to cases where it is felt that a self-governance modification decision:

- is likely to prejudice unfairly the interests of a party to the code, or cause that party to be in breach of an agreement (this test is used in the MRA and SPAA); and
- would not better facilitate the applicable code objective.

5.22. On reflection, we do not believe that appeal thresholds based on "x% of a constituency" or those which require appellants to have already notified concerns during the consultation process would be helpful to smaller participants that may be prejudiced by the outcome of a self governance decision. We do not therefore believe that a self-governance appeals framework should incorporate these features.

5.23. We propose that the appeals for self-governance modification decisions should be heard by Ofgem. We note that Ofgem already acts as an appeal body under the MRA, and the SPAA codes and that, to this point, relatively few appeals to Ofgem have been raised. We propose that the following courses of action could be available to Ofgem in the event of an appeal:

- quash the code panel's decision and refer the matter back to the panel for reconsideration (the panel could take the same decision again or a different one);
- quash the code panel's decision and have Ofgem take the decision; or
- affirm the panel decision (thereby declaring the appeal unsuccessful).

5.24. We also propose that a forum be established under each of the codes to act as an interim assessment body before an appeal is submitted to Ofgem. The forum would be comprised of code parties. Its role would be to represent the views of parties and determine matters referred to it. Each party would be entitled to send an authorised representative to attend, speak and vote at the meeting. We propose that Ofgem could attend and speak (but not vote) at these meetings. We believe that such a forum could increase the chances of industry resolving disputes itself and hence reduce the number of formal appeals that are raised with Ofgem. We note that similar arrangements are already in place under the SPAA and MRA.

5.25. We propose that Ofgem should be able to decline to hear an appeal if it considers the case to be frivolous, vexatious or to have no reasonable prospect of success. We also propose that there should be a time limit within which an appeal to Ofgem must be made. We invite views on what such a time limit should be (we note that under the MRA and SPAA, an appeal to Ofgem must be made within ten working days of the MRA/SPAA Forum having reached a decision). Finally, we propose that Ofgem should have the power in certain circumstances to require parties to bear the costs incurred by Ofgem through an appeal (this right could be conferred by the codes if code parties were willing to raise modification proposals to this effect).

5.26. We have also considered whether appeals of self-governance decisions should be heard by a third party arbitrator rather than by Ofgem. We consider that all appeals should be heard by Ofgem. However, if it becomes apparent over time that the self-governance arrangements are not operating effectively and that excessive numbers of appeals are being raised, we would consider again whether appeals should be heard by an independent arbitrator or other alternative dispute resolution forum such as expert determination.

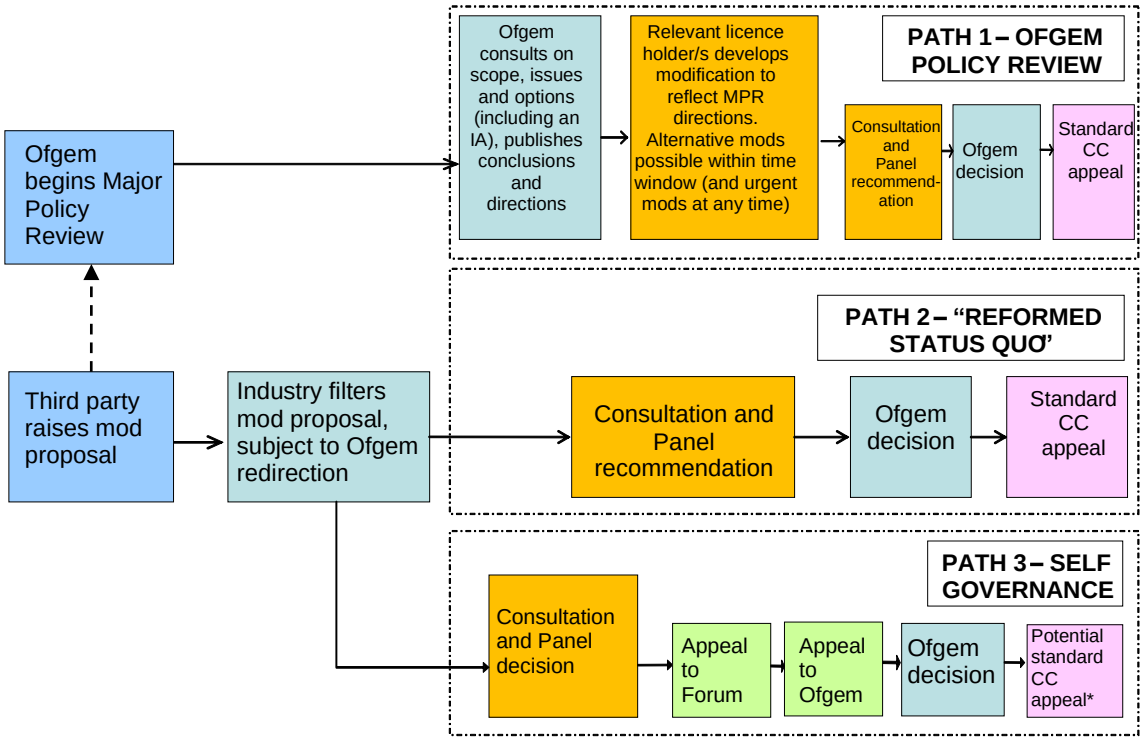
5.27. We have been considering whether recourse to the Authority under a self-governance framework would mean the Authority was taking a decision that was appealable to the Competition Commission. To the extent that the Authority was

giving or refusing to give consent (for example, where Ofgem takes the decision itself following an appeal request), such decision could be appealable to the Competition Commission. However, any decision by Ofgem to refer a decision back for a code panel for reconsideration would not be appealable to the Competition Commission. We hope the proposals outlined above would reduce the likelihood of appeals being sought. We also note that self-governance matters are generally unlikely to give rise to concerns of such magnitude that they would justify the notable costs that the appellant might bear in a Competition Commission appeal.

Outline of the proposed package of reforms

Figure 1: Proposed new framework

5.28. This figure outlines the proposed MPR and self-governance processes.



* As noted above, whether an appeal to the Competition Commission is available for self-governance code modifications would depend on the type of decision taken by Ofgem.

Appendices

Index

Appendix 1 - Consultation responses 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 18 September and should be sent to:

Andy MacFaul
Head of Better Regulation
Ofgem
9 Millbank
London
SW1P 3GE

020 7901 7083
andrew.macfaul@ofgem.gov.uk

1.3. Unless marked confidential, all responses will be published by placing them in our library and on our website 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 using the contact details above.

Consultation questions

Chapter 2: Key issues and objectives

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 MPR process enable key strategic issues 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 MPR 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 3: Determining the code modification pathway

Question 1: Do you agree that, once a modification has been raised, the filtering decision should be taken by the relevant panel, subject to an Ofgem veto that could be deployed at any point before a final decision on the proposal has been made?

Question 2: Do you agree with the proposed criteria that should be applied to assessing whether a modification falls into Path 1 or Path 2? Is further guidance necessary?

Question 3: Do you agree with our proposals for redirecting modification proposals between Paths 3 and 2?

Question 4: Should code parties be able to make requests to Ofgem at any time that they can raise an urgent modification proposal to existing arrangements that are the subject of an MPR? Do you agree that there should be a moratorium for non-urgent modifications to existing arrangements that are the subject of an MPR?

Chapter 4: Major Policy Reviews

Question 1: Do you agree that Ofgem should retain the flexibility to vary the MPR process according to the complexity of the issues involved?

Question 2: What are your views on the options for determining the outcome of an MPR?

Question 3: Do you support our proposal that the industry should be given the responsibility of drafting appropriate MPR-related code modifications, with Ofgem having a power to draft them only if the industry fails to do so within as specified time period?

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

Question 5: Do you support our proposal for a time-window in which subsequent code modifications could be proposed after the completion of an MPR?

Question 6: Do you agree that Ofgem should be able to revise its MPR conclusions in the light of subsequent new information?

Chapter 5: Self-governance

Question 1: Do you agree that the industry should draw up proposals for panel and voting arrangements and submit them as part of a self-governance package to Ofgem for approval?

Question 2: Do you agree with our proposals for redirecting modifications from Path 3 to Path 2?

Question 3: Do you agree that there should be general appeal rights equally applicable to all code participants? Do you agree with the proposed grounds for appeal?

Question 4: Do you agree that Ofgem should hear appeals of self-governance modification decisions? Do you support the proposals in respect of interim forums, time limits and frivolous or vexatious appeals?

Appendix 2: Impact assessment

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 – Impact assessment

This appendix sets out an assessment of the impact of our proposed package of reforms.

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

1.1. The consultation document that we published in December 2008 included our initial assessment of the impact of our proposed package of reforms.

1.2. Some respondents expressed scepticism about the conclusions of our December 2008 impact assessment. They considered that there was too little information in it to form a view or that too many assumptions had been made on the cost savings. They also noted that the reforms would introduce new processes, such as the filtering stage, which would need to be accounted for when assessing costs and timeliness. It was also pointed out that while the MPR proposals might provide cost savings by preventing a piecemeal approach to change, they might not reduce the time taken to develop detailed modification proposals because the issues would not be any less complex or controversial. Some respondents agreed that the savings from avoiding dual assessment of self-governance modifications could be substantial.

1.3. In the preceding chapters we have where possible provided more information on our proposed package of reforms. However, there remain some aspects of the package that have yet to be fully worked up and others where we are inviting industry to draw up their own proposals.

1.4. We do not agree that the filtering process would require detailed, time-consuming analysis that might detract from the ability of the overall package to increase the efficiency of the governance process. We envisage that this would largely be a qualitative assessment, since the idea is to streamline the process and not to add another stage to it.

1.5. Some questioned the validity of the electricity cash-out case study. There was scepticism about the potential cost savings of applying the MPR process to cash-out reform. Respondents also noted that the existing cash-out arrangements had evolved from an increasing level of understanding and analysis over time and that this has been obtained as a result of various competing modifications submitted since the commencement of NETA. They argued that the MPR process would not allow for such evolutionary thinking.

1.6. In this IA we again evaluate the case for reform against the objectives of the Review and then consider other impacts.

Key issues

1.7. In chapter 2 we identified a number of key issues with the existing codes governance framework. In summary, they are as follows:

- **inability to progress major policy reforms**: the current arrangements did not facilitate the delivery of major policy reforms in key strategic areas (such as electricity cash-out and transmission access. In some cases reforms were not delivered and in other cases they were delayed, which meant in turn that the benefits to consumers of those reforms were not delivered or were delayed;

- **inefficient decision-making processes**: the current arrangements were inefficient in that Ofgem made decisions on matters that had little or no impact on consumers and/or competition and our analysis often duplicated work done by the industry; and

- **complexity and barriers to entry for smaller players and new entrants:** the current arrangements were complicated and made it difficult for new entrants and small players to engage in and influence major policy debates.

The package of reforms

1.8. The proposed package of reforms is outlined in chapter 2. In summary, we are proposing that significant reforms requiring changes to the industry codes should in future be developed through a new MPR process. This process was described in more detail in chapter 4. The MPR process would be led by Ofgem and could be initiated either when Ofgem identifies a significant policy issue or when we consider that a code modification, raised in the usual way, gives rise to significant policy issues. As we noted in our June and December 2008 documents, the MPR conclusions could take the form of detailed policy principles and a direction on code panels/relevant licence holders to raise modification proposal(s).

1.9. We are also proposing that modification proposals with only a minimal impact on consumers, competition or our other statutory duties could be dealt with through a new self-governance process. This process was described in chapter 5.

Assessment of reforms against the review's objectives

1.10. 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 MPRs and self-governance processes should provide several important benefits.

Cost-effectiveness and efficient change management

1.11. The MPR process should 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 MPR process to:

- reduce the need for multiple piecemeal code modifications and thus multiple assessment processes undertaken by industry and code panels;
- reduce the potential for multiple impact assessments by Ofgem in the event that piecemeal code modifications are raised over different time periods[9];
- 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 MPR process; and
- make it more likely that an optimal outcome for consumers would be achieved.

1.12. The introduction of self-governance processes should enable cost savings and efficiencies by reducing the role of Ofgem in modifications with minimal implications for consumers, competition or our other statutory duties. It should also ensure that Ofgem resources are focused 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 more quickly.

1.13. We set out below a qualitative analysis of the cost savings and efficiency benefits that could be provided by introducing MPRs and self-governance.

[9] 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 an MPR. Thus, there remains a risk that both industry and Ofgem will have to undertake analysis under the Path 2 process.

Proportionality

1.14. We believe that the introduction of a new major policy review process represents a proportionate response to the difficulties that the industry has faced in pursuing major reforms under existing governance processes. Recent experience in the context of electricity transmission access demonstrates the need for governance reform and the need for more coordination and leadership from Ofgem. Looking forward, we believe that the MPR process could deliver significant benefits as the industry seeks to address the challenges of climate change and security of supply.

1.15. As set out in chapters 2 and 4, the MPR process would be highly transparent and would give interested parties several opportunities to influence our thinking. Interested parties subsequently would be able to raise alternative modification proposals within a defined time period and, if new information suggested that it was necessary, Ofgem could revise any direction that it had issued. In addition, existing rights of appeal would be retained. As noted in chapter 4, we expect to conduct only one or two MPRs per financial year.

1.16. The introduction of self-governance should ensure that Ofgem's involvement in code modifications is proportionate to the issues being raised. Ofgem intends to step away from modifications with minimal impacts on consumers, competition or our other statutory duties. We consider that this would be consistent with our better regulation duties.

Inclusivity, accessibility, transparency and effective consultation

1.17. MPRs 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.

1.18. As we have noted above, we consider that the existing code modification arrangements are complex and that small participants and consumers find it difficult to engage in code change processes. We consider that MPR processes should help to alleviate these concerns and facilitate better engagement by providing a single process (as opposed to multiple modification processes) in which to participate.

1.19. The process of filtering modification proposals should provide transparency benefits by providing information to industry participants on those modifications that have non-trivial impacts on consumers or competition. This in turn may assist industry participants in identifying the modification workgroups they might wish to participate in and the modifications to which they might wish to respond. Our proposal to allow parties, within certain specified time limits, to raise modification proposals after the publication of an MPR-related direction should ensure that all parties have the opportunity to put forward their own modification proposals and thus enhance the consultation process.

Rigorous and high quality analysis

1.20. MPRs should improve the analysis undertaken on key strategic policy issues. This is because the MPR 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. Introducing a time window for alternative modification proposals, after we issue MPR-related directions, would enable parties to submit their own proposals but without affecting our ability to consider them in the round and in a timely way. The proposal to enable the Authority to modify its directions in the light of new information also helps to promote rigorous, high quality analysis.

Flexible change processes

1.21. The introduction of MPR and self-governance should provide for more flexible change processes and ensure that Ofgem and industry resources are focused on those issues that have material impacts on consumers, competition or our other statutory duties. Our proposals in respect of time windows for alternative modification proposals, considering urgent modifications and enabling the authority to modify its directions are all intended to promote flexible change processes.

Independent and objective processes

1.22. MPRs 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.

Quantitative evaluation of cost savings

1.23. In addition to the qualitative assessment of the package of reforms set out above, we carried out a quantitative assessment of the impact of these proposals on the ability of the code governance arrangements to deliver more efficient change processes.

1.24. We expect that the self-governance process would reduce the cost of assessing Path 3 modifications because Ofgem would no longer be assessing such proposals.

1.25. We expect that the MPR process would deliver better policy outcomes more quickly, efficiently and effectively than the current arrangements. We therefore consider that the Path 1 process would deliver cost savings in a range of circumstances, including for example where there are major public policy issues and/or significant cross-code issues.

1.26. As we have noted above, we also consider that the MPR process should ensure that the benefits to consumers of major policy reforms in key strategic areas such as electricity cash-out or transmission access are not delayed or hindered.

1.27. The impact of improved governance processes on the delivery of key policy reforms is difficult to quantify and dependent on the area of policy being reformed. For the purposes of the initial IA that we published in December 2008, we undertook a case study on electricity cash-out reform to illustrate the benefits and savings that the MPR process could provide. We set this out again below.

Electricity cash-out reform case study

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

1.29. The electricity cash-out arrangements are a fundamental part of the regulatory design of the electricity industry trading arrangements. They

- are the mechanism through which market participants are incentivised to balance the electricity they bring onto the system through generation or purchases with that which they take off through consumption and sales;
- underpin competition in the wholesale electricity sector and the efficient operation of the electricity system; and
- provide incentives on parties to ensure that they have sufficient contracted generation to meet customer demand.

1.30. The cash-out arrangements are therefore extremely important to ensure that there is sufficient generation capacity in the market and therefore security of supply.

1.31. The detailed rules for electricity cash-out sit in the BSC. 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 that we published in June 2008.[10] They illustrate some of the problems that the present MPR proposals are designed to address.

[10] *Critique of the Industry Codes Governance Arrangements, a report for Ofgem*, Brattle, June 2008. See pages 31-35.

Background – electricity cash out modifications under the BSC

1.32. Ofgem has been looking at electricity cash-out reform since at least August 2003, when modifications P136 and P137 (marginal cash-out) were raised.

1.33. 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.

1.34. 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 IAs (namely an IA 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, an Issues Group was formed after those decisions were taken to discuss other possible changes to cash-out. Whilst no further modification proposals have so far resulted from that group, it is possible further piecemeal reform proposals could yet be raised.

1.35. 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.

1.36. 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 via a single package of modifications.

1.37. Indeed, the introduction of an MPR 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 the MPR process

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

1.39. In our view, an MPR 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 industry parties); and
- six months to work up policy conclusions.

1.40. A further six months might have been required to process and evaluate the resulting implementing modifications.

1.41. 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 MPR route. We consider there would have been benefits to consumers from having more efficient electricity cash-out arrangements in place several years sooner.

1.42. 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 an MPR had resulted in the implementation in 2005 of a modification like P217.

1.43. One respondent to the December IA suggested that P217A meant that there was simply a redistribution of money from "good balancers" to "poor balancers" with no direct savings to customers. That respondent noted that there might be cost savings as a result of reduced risk management costs but these would hardly amount to £37m per year. The respondent expressed the view that under P217A cash-out prices would be similar to those under the pre-P194 regime and that therefore, when considered alongside the implementation costs faced by Elexon and the industry, this "illustrated the danger of change for change's sake".

1.44. Whilst Ofgem recognised in its decision letter on P217 that the analysis of the costs of system pollution relies on assumptions which are difficult to quantify accurately, we consider that the IA demonstrated that a degree of pollution does exist, and that P217 and P217A would to a large extent remove that pollution.

1.45. We recognise that P217A would represent a redistribution of money from good balancers to poor balancers. In the short term, consumers would not benefit from the full savings to the extent that good balancers were already passing on the system pollution costs to their customers. However, the pre-P217A arrangements represent a distortion to competition and incentivise parties over the longer term to invest in balancing capabilities (forecasting, balancing contracts) to avoid imbalance

charges which do not represent the true cost of energy. These additional costs may ultimately be passed onto customers. By contrast, the reduction in the pollution of cash-out prices following the introduction of P217A should help to ensure that parties are not artificially incentivised to invest in balancing capabilities to avoid imbalance charges that do not reflect the true cost of energy.

1.46. As regards direct savings, under the MPR process we assume there would have been a maximum of three or four worked up modifications rather than the nine that were actually put forward. We consider this to be a cautious assumption. It is quite possible that only one 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.

1.47. 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.

1.48. The cost to Elexon of analysing BSC cash-out modifications is perhaps £100k per modification. On that basis Elexon might have saved around £500k from the number of modifications being reduced from nine to four. 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 National Grid in providing analysis on the likely impact of the modifications would have been reduced. Whilst we have no data from which to estimate National Grid's savings, we assume these could have been as high as £100k.

1.49. 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.

1.50. 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.[11] 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 eight 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.

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

[11] *The Brattle Report*, June 2008.

Cost savings achieved through self-governance

1.52. 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.

1.53. The back-casting exercise carried out in 2008 suggested that up to half of all modifications might be suitable for the self-governance route.

1.54. 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).

1.55. We estimate that although self-governance" modifications would be up to one 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

1.56. We consider that the package of reforms including self-governance and MPRs should provide significant benefits to consumers. We illustrated this above in our case study on electricity cash-out reform.

1.57. We consider that MPR should help to ensure that policy reforms within key strategic areas are progressed in a timely manner so that 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 MPRs that we have already identified above to the extent that these savings are passed through to consumers by suppliers.

1.58. 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 MPRs, should help facilitate engagement from consumers and hence improve policy making with benefits to competition.

Impact on competition

1.59. To the extent that the future MPRs 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.

1.60. 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

1.61. 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 TAR process; where smaller generators have found it difficult to engage in the code modification and policy development process.

1.62. We consider that the introduction of MPR processes should help to facilitate engagement in the reform processes from smaller industry parties. 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. However, it is difficult to estimate the extent of these benefits.

Impact on health and safety

1.63. We do not believe that the proposals would have any implications for health and safety. If a modification proposal was likely to impact on health and safety it would not be suitable for the self-governance process and, if it had started down the self-governance route, Ofgem would redirect it to Path 2.

Risks and unintended consequences

1.64. In this section we discuss the potential risks and unintended consequences associated with the MPR and self-governance processes.

MPR risks

1.65. In respect of the MPR process, the major risk is simply that the new process is not as effective as anticipated. Our expectation is that the new process would 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.

1.66. 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. This risk could be triggered under options 1 and 2 (as set out in chapter 4) where:

- industry participants use the modification process to undermine the outcomes of the MPR. This risk could be mitigated by giving Ofgem backstop powers to raise its own modification(s) if satisfactory modifications are not put forward; and
- the MPR conclusions are not expressed with sufficient certainty and clarity for industry participants to understand how they could best be implemented through code modifications. It would be important for Ofgem 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. Ofgem would also need to work with industry to address any concerns of this nature that arise.

Self-governance risks

1.67. 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 would not make a significant difference to the cost of assessing modifications (relative to the *status quo*). 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.

1.68. Our view is that the first of these risks is small but realistic and would need to be carefully managed (for example, through the design of the filtering process) to ensure that only decisions with minimal implications for consumers, competition or our other statutory duties are progressed through Path 3.

1.69. Equally, we consider 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.

Post-implementation review

1.70. In our view, if our proposals are implemented, it would 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.

1.71. The review would, at a high level, compare the new regime with the *status quo*. It would also examine in detail at least one instance of the operation of the new processes.

1.72. 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 MPR process has compared with the expectations set out in Ofgem's final IA on these proposals.

1.73. We would welcome further views from industry participants on our assessment of MPRs and self-governance against the objectives of the Review.

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 UK statute (such as the Gas Act 1986, Electricity Act 1989, Competition Act 1998, Utilities Act 2000, Enterprise Act 2002 and Energy Acts of 2004 and 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.[12] 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.[13]

1.3. 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, existing 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 interconnectors.

1.4. 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;[14]
- the need to contribute to the achievement of sustainable development;[15] and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[16]

12 Entitled "Gas Supply" and "Electricity Supply" respectively.
13 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.
14 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.
15 This obligation was introduced by the Energy Act 2008 with effect from 26 January 2009. See below for more details.
16 The Authority may have regard to other descriptions of consumers.

1.5. 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[17] 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; and
- secure a diverse and viable long-term energy supply.

1.6. In carrying out these functions, 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.

1.7. 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 Britain. The Authority is a designated National Competition Authority under the EC Modernisation Regulation[18] and is 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.

The Energy Act 2008

1.8. The Energy Act 2008 modified the general duties of the Authority in carrying out its functions under the Gas Act and the Electricity Act.

1.9. When carrying out its functions in the manner which it considers is best calculated to further its principal objective, the Authority must now 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

17 Or persons authorised by exemptions to carry on any activity.
18 Council Regulation (EC) 1/2003.

demands for electricity and gas are met and that licensees are able to finance their regulated activities.

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 Authority already takes account of sustainable development in its decisions but the changes mean that increased weight is attached to such considerations.

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 or 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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