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Our Reference:

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Date : 9/10/2009

Dear Jenny,

### **Code Governance Review: Governance of Charging Methodologies – Initial Proposals**

Scottish and Southern Energy plc (SSE) and Scotia Gas Networks (SGN) welcome the opportunity to comment on the above proposals. In our view, securing the proper treatment of charging methodologies is key to the success of the code governance review.

We strongly support the principle of opening up Transmission charging methodologies to change proposals by network users and customers and as such, we welcome Ofgem's initial view that there are significant benefits to be realised from doing so. We also welcome Ofgem's proposal to prioritise reform of the governance of the gas and electricity Transmission charging methodologies in the first instance. We believe that this is the most appropriate focus given the GB application of Transmission charges, the scale of the costs involved and the significant levels of investment activity at present in Transmission arrangements.

Ofgem request views on the most appropriate governance option for the charging methodologies and consider that the case is finely balanced between Option 2 (refining the existing licence arrangements) and Option 3 (incorporating the methodologies into the existing industry codes). However, we do not agree that the case for Option 2 or Option 3 is finely balanced and believe that there is a clear case for implementing Option 3 over Option 2.

Indeed, this view is supported by Ofgem's qualitative assessment of the options set out in its September 2008 paper, which clearly demonstrated that Option 3 better meets the objectives of the governance review compared to Option 2 in **5 out of the 8** review criteria (and is no worse than Option 2 in the remaining 3 criteria). We discuss these criteria in detail in the attached Appendix. In particular, the right of appeal to the Competition Commission under Option 3 would increase accountability of NGET. In addition, under Option 3 charging methodology modification proposals would be considered in a transparent, objective and independent manner (rather than under a process that is controlled by NWOs) which is a

fundamental prerequisite of an effective charging methodology governance regime. Option 3 would also be consistent with the conclusions of the electricity distribution structure of charges project, where the new common distribution charging methodologies are to be incorporated into the DCUSA with effect from 1<sup>st</sup> April 2010.

In addition, we have a number of serious concerns about the conclusions drawn from the quantitative analysis in the paper in relation to Option 2 compared to Option 3 which we have set out in detail in the attached Appendix. However, in short, we believe that the statements throughout the consultation paper that Option 2 could bring about the potential efficiency savings / benefits of opening the charging methodologies at a lower implementation cost than Option 3 are incorrect and unsubstantiated.

In conclusion, therefore, we firmly believe that if Ofgem decide to implement Option 2 the potentially significant benefits of opening up the charging methodologies to change proposals by network users and consumer representatives will not be realised and in-fact will deliver no real benefit relative to the status quo. If Ofgem want to open up the charging methodologies and realise the associated benefits, Option 3 (incorporating the charging methodologies into the existing industry codes) should be implemented.

We have set out our detailed response in the attached Appendix.

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

Yours sincerely

Rhona McLaren  
Regulation Manager

## **Appendix: Specific Questions**

### **Chapter Three**

#### **Question 1: Do you agree with the output from the assumptions made within the quantitative analysis undertaken?**

We would agree with the premise that only modest efficiency savings would be required in order to outweigh the quantifiable costs associated with administering multiple change proposals. This is particularly the case given that we believe there is a natural limit to the number of modification proposals that can be raised and that additional modification proposals on the charging methodologies will displace other, lower priority modification proposals thus limiting the increase in the total number of proposals raised. We therefore strongly support Ofgem's initial view that there are significant benefits in opening up the charging methodologies to change proposals by network users and consumer representatives.

However, we do not agree with the output from the analysis in relation to the comparisons drawn between Option 2 and Option 3 and we comment on each of the three comparisons in turn below.

*“First, there was some industry evidence to suggest that the assessment and implementation costs associated with additional modification proposals might be lower under Option 2 than under Options 3 and 4. Specifically, while industry responses to Ofgem’s September 2008 consultation document differed in their opinions about the relative costs of Options 3 and 4, none of the quantitative estimates suggested that Option 2 would be a more expensive alternative.”*

It is clear that not stating that Option 2 would be more expensive does *not* equate to saying that the costs of Option 2 might be lower. Furthermore, on detailed review of Appendix 3 – Quantitative Analysis, the only “industry evidence” we can find to support this statement is provided on page 49. This evidence consists of three suppliers’ costs estimates provided in their responses to Ofgem’s September 2008 consultation paper. Of the three, supplier 1 estimated that Option 3 would be more costly for them than Option 2 while the other two suppliers estimated that Options 2 and 3 would result in the same level of additional costs being incurred. There is no rationale provided for the estimated cost difference between Options 2 and 3 from supplier 1. In addition, while one supplier may believe that their costs may be lower under Option 2 than Option 3, other parties (including NWOs) are likely to incur higher costs under Option 2 than Option 3.

We therefore believe that the above statement is incorrect and unsubstantiated.

*“Secondly, Option 2 would not require resources to be spent on establishing a new industry code (as in Option 4) or modifying existing industry codes (as in Option 3)”*

We can find no supporting analysis or indeed reference in Appendix 3 (Quantitative Analysis) to this statement. Again, we would therefore dispute that this conclusion can be drawn from the data.

In addition, the statement is incomplete. While it is correct that Option 2 would not require resources to be spent on establishing a new industry code or modifying existing industry codes, this is because Option 2 is based on modifying the existing licence arrangements

rather than code arrangements. However, it is clear that Option 2 would require the network licences to be amended and a new set of consultation rules and processes to be developed to allow network users to propose modifications to NWOs. This can be compared to Option 3, where the methodologies would become subject to rules and processes that are already well established and understood.

Indeed, this was recognised by Ofgem in their earlier consultation paper which stated “*A potential benefit of Option 3 is that the charging methodologies would become subject to code modification rules and processes that are well established. This Option would avoid the need to create a new set of consultation rules and processes under the licence which would occur under Option 2.*”<sup>1</sup>

*“Thirdly, the cost associated with Option 3 could be higher as a result of charging methodology decisions becoming appealable to the Competition Commission”*

This is the only statement that is quantified in the analysis and is solely a consequence of charging methodology decisions becoming appealable to the Competition Commission under Option 3. We accept that, in the event of a decision being appealed to the Competition Commission, a higher level of costs might be incurred. However, as is recognised elsewhere in the paper, there are clearly significant benefits including increased accountability that comes with a “ready-made” appeal mechanism to the Competition Commission and while it is difficult to quantify such benefits, they should be referenced alongside any statement regarding the higher costs of Option 3 due to the right of appeal.

In addition, Ofgem stated in their September 2008 paper<sup>2</sup> that under Option 2 “*consideration could be given to whether network users and NWOs should have rights of appeal on Authority decisions to the Competition Commission under the Energy Act 2004, and if so, the criteria to be applied in allowing rights of appeal*” Therefore, in order to present a fair and balanced analysis, the potential costs associated with introducing an appeals mechanism under Option 2 (in order to be as accountable as Option 3) should be highlighted when comparing the options.

In conclusion, therefore, we strongly believe that the statements throughout the consultation paper suggesting that Option 2 could bring about the potential efficiency savings / benefits of opening up the charging methodologies at a lower implementation cost than Options 3 or 4 are not supported by the analysis presented in the paper or indeed correct. The only robust conclusion that the quantitative analysis can reach in relation to Option 2 compared to Option 3 is regarding the cost of the appeals mechanism that is in place under the latter and where it does so, the associated qualitative benefits of a right to appeal and the potential costs of introducing an equivalent appeals mechanism under Option 2 should also be highlighted in order to present a fair and balanced analysis.

**Question 2: Are there any factors that you believe should have been considered in this analysis?**

In relation to the qualitative assessment presented in Chapter 3 of the paper, we are concerned that Ofgem consider Options 2, 3 and 4 together when assessing their impact on consumers, sustainable development and competition. That is, Ofgem do not compare the benefits of

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<sup>1</sup> Ofgem, “Code Governance Review: Charging Methodology Governance Options, 17th September 2008, p15

<sup>2</sup> Ofgem, “Code Governance Review: Charging Methodology Governance Options, 17th September 2008, p11

Options 2 against those of Option 3 as part of the analysis presented in Chapter 3. Ofgem state that they have not changed their previous assessment of the Options against the Code Governance Review objectives set out in their September 2008 paper and as such, they have not repeated it in this paper.

However, we believe that as a very minimum a summary of the conclusions of their previous assessment should be provided given that Ofgem's earlier assessment clearly demonstrated that Option 3 has significant benefits over and above Option 2. In our view, this is a serious omission given that Ofgem are asking for views as to which of the two options would be the most appropriate to introduce for governing charging methodologies.

We have therefore listed each of the 8 review objectives below with Ofgem's previous comments highlighted underneath for each of reference.

1. Promotion of inclusive, accessible and effective consultation

*"We consider that Option 3 is likely to provide additional accountability benefits when compared to Option 2. In addition, under Option 3, proposals would be subject to code governance and industry panel assessment which is arguably more inclusive than consultations undertaken solely by NWOs (which would be the case under Option 2)."*

*"It should also be noted that accountability would be increased further [under Option 2] if network users are also given the right to appeal decisions on changes to methodologies to the Competition Commission".*

2. Governed by rules and processes that are transparent and easily understood

*"A potential benefit of Option 3 is that the charging methodologies would become subject to code modification rules and processes that are well established. This Option would avoid the need to create a new set of consultation rules and processes under the licence which would occur under Option 2."*

3. Administered in an independent and objective fashion

*"We consider that Option 3 should help to ensure that charging methodology change processes are administered in an independent and objective fashion. As such this may provide comfort to users that proposals are being managed impartially and not confined wholly within the purview of the NWOs as is currently the case [and would continue to be the case under Option 2]."*

4. Rigorous and high quality analysis of the case for and against proposed changes

*"Under Option 3 changes would be subject to Code Panel assessment and governance processes as opposed to being the responsibility of NWOs.....we nevertheless are of the view that subjecting change proposals to industry analysis through the codes process is likely to be more objective relative to the analysis being solely undertaken by NWOs, who may have particular commercial interests in certain outcomes."*

5. Cost effectiveness

*"Option 3 raises similar issues to Option 2 in terms of cost effectiveness."*

6. Flexible rules and processes leading to efficient change management

*"We consider that Option 3 should provide largely the same costs and benefits under this principle as Option 2. However, one incremental benefit of Option 3 over and above Option 2 is that it allows charging methodology changes to be coordinated with any consequential*

*code changes that might be triggered.....The inclusion of the charging methodologies in the codes should promote greater alignment and coordination in this area which should lead to efficiencies in change management.”*

7. Proportionate regulatory burden

*“We consider that Option 3 raises similar issues of regulatory burden to those already discussed under Option 2.”*

8. Other risks and issues

*“As with Option 2, Option 3 also raises the same revenue risk issues for NWOs.”*

In conclusion, therefore, Ofgem’s qualitative assessment clearly demonstrates that Option 3 better meets the objectives of the governance review compared to Option 2 in **5 out of the 8** review criteria (and is no worse than Option 2 in the remaining 3 criteria). We therefore believe that there is a clear case for moving the charging methodologies to within the scope of the appropriate industry codes i.e. Option 3.

#### Chapter Four

#### **Question 1: Which governance Option do you consider is the most appropriate for charging methodologies?**

As stated above, we believe that there is a clear case for moving the charging methodologies to within the scope of the appropriate industry codes i.e. Option 3 and this view is supported by Ofgem’s qualitative assessment of the options undertaken in September 2008. It is also significant that Ofgem’s updated consideration of the options states that there was little or no support from NWOs for Option 2 (which would require additional time and resource commitment from NWOs) while the majority of users supported Option 3.

In terms of the four advantages listed by Ofgem for Option 2 (refining the existing licence arrangements), the first two consist of retaining the existing, status quo arrangements i.e. the licence obligation and the existing charging methodology forums; the third is simply the advantage of opening up the charging methodologies per se and is not specific to any of the options for governance; and the fourth is that the implementation costs will be lower under Option 2 than under Options 3 and 4. This is based on the conclusions of the quantitative analysis presented in Chapter 3 and Appendix 3 which we consider to be unsubstantiated (please see our response to Question 1, Chapter 3 above). Therefore, we do not agree that the advantages listed for Option 2 are true advantages.

However we do agree with the disadvantages highlighted by Ofgem for Option 2, in particular the lack of a right of appeal to the Competition Commission and therefore the lack of accountability. Also, Ofgem recognises that the NWOs would retain control of the process under Option 2 and as such, we do not believe that this is very different from the status quo other than the increased resource commitment required from the NWOs to fulfil their obligations in relation to charging methodology modification proposals. For example, following a recent consultation undertaken by NGET on GB ECM-17 (TNUoS Charging Methodology), NGET decided no change was necessary and the proposals were not therefore progressed.

We agree with the advantages listed for Option 3 and will not therefore repeat them here. Ofgem also state that their initial view is that charging methodology modification proposals

should be subject to the same decision timeframe as industry code modifications, thereby allowing decisions on charging methodology proposals to be aligned with decisions on other related code modifications. We would support this proposed approach.

However, one of the disadvantages of Option 3 put forward by Ofgem is that it will require a two stage implementation process – the licence amendments followed by the relevant code modification proposals – which Ofgem consider to be a more complicated process than that required to implement Option 2. However, Option 2 would also require NWOs licence amendments, followed by the creation of a new set of consultation rules and processes. In addition, Option 2 may require the creation of new rights of appeal on Authority decisions to the Competition Commission and development of the criteria to be applied in allowing such rights of appeal. We therefore consider that the implementation process for Option 3 is at least no worse than that required to implement Option 2.

Against this background, we do not consider that the case for Option 2 or Option 3 is finely balanced. Indeed, we firmly believe that if Ofgem decide to implement Option 2 i.e. refining the existing licence arrangements, the potentially significant benefits of opening up the charging methodologies to change proposals by network users and consumer representatives will not be realised and in-fact will deliver no real benefit relative to the status quo. If Ofgem want to open up the charging methodologies and realise the associated benefits, Option 3 (incorporating the methodologies into the existing industry code governance) should be implemented.

**Question 2: Do you agree that we should initially focus on gas and electricity transmission charges, with gas distribution potentially to follow as a second phase?**

Yes, we support Ofgem’s initial view that in taking these proposals forward the focus should in the first instance be on Transmission methodologies in gas and electricity. Given their GB application, the scale of the costs involved and the significant levels of investment activity at present in Transmission and the potential to create significant windfall gains and losses, we believe that reform of the Transmission arrangements should be treated as a priority relative to gas distribution. However, this would not preclude distribution charging methodologies being placed within a similar governance arrangement in the longer term, once the Transmission arrangements had bedded in and been shown to work effectively.

**Question 3: Do you agree that annual/biannual change and implementation windows are the most appropriate mitigation measures to progress going forward for all the options?**

We are concerned that the introduction of change and implementation windows could lead to a flood of change proposals requiring to be assessed within a relatively short period of time. In addition, such a window could potentially mean that decisions on charging methodology proposals would not be able to be aligned with decisions on other related code modifications.

Rather, we believe that bi-annual change implementation dates (say, 1<sup>st</sup> April and 1<sup>st</sup> October) would be the most appropriate mitigation measure. Under this measure, change proposals could be raised at any time during the year but, if approved, they would not take effect until the next feasible implementation date. This would allow sufficient time for a thorough assessment of change proposals while also spreading the cost and resource required for such assessments across the year. This approach would also be consistent with a number of the

existing codes and customer contract rounds and would also allow lead times to be agreed before implementation thus ensuring sufficient notice is given to all parties.

**Question 4 : Do you consider a 3 or 4 month window to be sufficient time to consider modification proposals ? Please indicate your preference for either 3 or 4 months?**

As stated under Question 3 above, our preference is for bi-annual change implementation dates of 1<sup>st</sup> April and 1<sup>st</sup> October and not a change window. Indeed, if the charging methodologies are incorporated within the existing industry codes, it would be at odds with the arrangements for other modification proposals to restrict the raising of charging methodology modification proposals to a 3 or 4 month period.

**Question 5: Do you agree with our approach to defining “affected parties” who would be entitled to raise modification proposals?**

Under Option 3, we support the proposal that “affected parties” are those parties who can raise modification proposals as provided for in the relevant code and other parties as designated by Ofgem, such as consumer representatives. However, it must be clear that the way in which this provision is implemented would not provide Ofgem with the ability to limit or restrict the ability of code parties to raise modification proposals. Similarly, under Option 2 we would support the Authority being able to designate affected parties who can raise modification proposals, subject to all the relevant network users being included as affected parties.