

Code Governance Review – Final Impact Assessment

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Target Audience: Gas and electricity industry participants, consumer representatives, Code Administrators and other interested parties.

Overview:

The industry codes are the contractual arrangements that underpin the electricity and gas wholesale and retail markets and which define aspects of the terms under which industry participants can access the electricity and gas networks. In November 2007, we launched a review of the arrangements for governing these industry codes to ensure that they were still fit for purpose given the wide range of changes that had occurred since the introduction of the codes and also given the scale of challenge the industry faces over the coming decade.

This document should be read in conjunction with our Code Governance Review - Final Proposals. It incorporates and pulls together initiatives previously consulted upon under various CGR work strands. Our Final Proposals include a wide range of changes to the industry codes, and seek to make existing governance processes more transparent and accessible, which is particularly important for small participants and consumer groups. The Final Proposals define a role for Ofgem to lead significant changes to the industry codes, propose that Ofgem steps back from some parts of the code arrangements that have minimal impact on consumers and propose to insert network charging methodologies into codes giving users the opportunity to propose change.

This document contains appendices setting out our assessment of the impacts of our Final Proposals on Significant Code Reviews and Self Governance, the Role of Code Administrators and the Governance of Charging Methodologies. This Final IA is published pursuant to our duty under the Utilities Act 2000 in relation to impact assessments.

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Context

The Authority is committed to policies and processes that are consistent with better regulation principles and that reduce administrative burdens on business while maintaining effective consumer protection.

As part of that commitment, in November 2007, we announced the Review of Industry Code Governance. We considered that such a review was timely given the changes that have occurred in the market, where the nature of participation is changing, particularly for new entrants and smaller players. The Authority's role in relation to code modifications has also changed with the introduction of additional statutory duties and the right of appeal to the Competition Commission.

In summer 2009, we consulted separately on our initial proposals for each of the Code Governance Review workstrands. This document pulls together the different CGR workstrands and sets out our Final Proposals for the Code Governance Review package.

There are no further documents planned but we have also published today our consultation on the form of the modifications required to a number of network companies' licences to bring effect to the Final Proposals. Further statutory consultations on licence changes will be required following this consultation. Lastly, a wide range of industry code modifications will be necessary to give effect to the Final Proposals. We expect these to be raised in the spring with full effect to be given to these proposals by end of the summer 2010.

Associated Documents

- [Open letter announcing review of industry code governance - Ofgem Ref: 284/07](#)
- [Corporate Strategy and Plan 2008-2013 - Ofgem Ref: 34/08](#)
- [Review of industry code governance - scope of review - Ofgem Ref: 92/08](#)
- [Code Governance Review: Charging methodology governance options - Ofgem Ref: 132/08](#)
- [Review of Industry Code Governance – Environment and Code Objectives, Ofgem open letter, 21 November 2008](#)
- [Review of Industry Code Governance – role of Code Administrators and small participant/consumer initiatives - Ofgem Ref: 173/08](#)
- [Review of Industry Code Governance – Code Administrators' Working Group - Ofgem open letter, 20 April 2009](#)

- [Review of Industry Code Governance - Environment and Code Objectives - Ofgem Ref: 66/09](#)
- [Code Governance Review – role of Code Administrators and small participant/consumer initiatives – initial proposals - Ofgem Ref: 85/09](#)
- [Code Governance Review: Major Policy Reviews and Self-Governance - Initial Proposals - Ofgem Ref: 84/09](#)
- [Code Governance Review: Governance of charging methodologies: Initial proposals - Ofgem Ref: 108/09](#)
- [Codes Governance Review Initial Proposals - illustrative licence modification drafting - Ofgem Ref: 133/09](#)

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Appendix 8 – Final Impact Assessment - Significant Code Reviews and Self-Governance

Summary

This appendix sets out an assessment of the impact of our Final Proposals for Significant Code Reviews (SCR) and Self-Governance. It builds on our initial impact assessments (IAs) and responses we received to the consultations on them. This IA is published pursuant to our duty under the Utilities Act 2000 in relation to IAs.

The IA concludes that our SCRs and self-governance proposals will make a strong contribution towards improving the efficiency of the codes governance regime. (Approximately £100m of costs might have been avoided in the area of electricity cash-out alone.) The proposals should facilitate participation by smaller code parties and better enable the industry to meet the major challenges facing it, such as addressing climate change and maintaining secure energy supplies. This will in turn deliver significant and lasting benefits for gas and electricity consumers.

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. The initial proposals document of July 2009 included a revised version of that IA.

1.2. On both occasions, some respondents expressed the view that there was too little information in it to determine the likely costs and benefits of our proposals. Some believed 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 and subsequent potential redirection of modifications, which would need to be accounted for when assessing costs and timeliness.

1.3. Some respondents stated that while the SCR proposals might provide cost savings by preventing a piecemeal approach to change, SCRs might not reduce the time taken to develop detailed modification proposals because the issues would not be any less complex or controversial. It was also suggested that any analysis undertaken by Ofgem as part of an SCR would need to be revisited when Ofgem came to appraise any actual SCR-related code modifications that were subsequently proposed.

1.4. Overall, some respondents believed that the SCR process, as proposed in July 2009, would increase cost and uncertainty for industry by increasing the likelihood of legal challenge to Ofgem's code modification decisions. By contrast, most respondents agreed that the overall savings from avoiding dual assessment of self-governance modifications could be substantial even if some of Ofgem's costs would in practice be shifted to industry.

1.5. In chapter 2 of our Final Proposals document, we have provided more information about our proposals for Significant Code Reviews and self-governance. In particular, stakeholders will note that in certain respects we have refined our SCR proposals in ways that we believe reduce costs to industry yet without reducing the potential benefits of governance reforms. In relation to self-governance, it remains for industry to draw up detailed proposals. In addition, in light of respondents' views we have chosen to replace the term 'Major Policy Review' with 'Significant Code Review' as we recognise that we might have inadvertently caused confusion amongst stakeholders as to our intentions. We believe the term Significant Code Review (SCR) better matches the intent of the proposals, which is to facilitate significant and complex changes to the industry code(s). For convenience and to minimise confusion in this document we refer to Significant Code Reviews even where referring to our initial proposals on July 2009.

1.6. As stated in July 2009, 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.

1.7. We acknowledge that the redirection of a modification from Path 3 to Path 2 might result in some wasted industry resource but reserve the right to redirect modifications whenever it becomes clear to us that a modification would have material effects on consumers.

1.8. Some respondents to the July 2009 IA continued to question the validity of the electricity cash-out case study, which concluded that costs of approximately £100m might have been avoided if an SCR had resulted in the implementation in 2005 of a modification like P217. Those respondents were sceptical about the potential cost savings cited. They 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 because of various competing modifications submitted since the commencement of NETA. They argued that the SCR process would not allow for such evolutionary thinking and also suggested that it was unlikely that a single SCR process would have led straight to the outcome achieved by P217A.

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

Key issues

1.10. Throughout this review (and in previous IAs) we have identified a number of key issues with the existing codes governance framework as follows:

- the current arrangements did not facilitate the delivery of reforms in key strategic areas (such as electricity cash-out and transmission access). In some

cases reforms were not delivered or were delayed, which meant in turn that the benefits to consumers of those reforms were not delivered or were delayed;

- inefficient decision-making processes, with Ofgem making decisions on matters that had little or no impact on consumers and/or competition and Ofgem analysis often duplicating work done by the industry; and
- the current arrangements were complicated, making it difficult for new entrants and small players to engage in and influence major policy debates.

The package of reforms

1.11. In summary, we propose that significant reforms requiring changes to the industry codes should in future be developed through a new SCR process led by Ofgem and 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 previous documents, the SCR conclusions could take the form of detailed policy principles and a direction on relevant licence holders to raise modification proposal(s). We are also proposing that modification proposals with a non-material impact on consumers, competition or our other statutory duties could be dealt with through new self-governance processes.

Scope of the SCR and self-governance proposals

1.12. We consider that any future significant code reform is likely to be mainly set around the three main commercial codes (BSC, CUSC and UNC). We cannot rule out SCRs impacting on other codes, though we consider the risk to be more limited. We have therefore proposed to include only the three main codes. This would not preclude us from revisiting other codes as part of some future work.

1.13. We are aware that introducing SCRs to just the three main codes could impose a risk on the successful conclusion of an SCR that is reliant, either wholly or in part, upon changes to codes other than the BSC, CUSC and/or UNC. However, given the likely nature of SCRs we consider it probable that impacts upon those 'secondary' codes will be limited to changes required as a consequence of, and in keeping with, changes made to the BSC, CUSC and/or UNC.

1.14. We have therefore proposed to introduce licence drafting to address these consequential changes. This would oblige relevant licensees to take all reasonable steps to ensure that "related industry codes" are consistent with the BSC, CUSC or UNC to the extent that a modification to the BSC, CUSC or UNC leads to inconsistency or conflict¹. This principle already exists in respect of some codes that have a direct and complementary relationship.

¹ This would be utilised primarily for consequential changes and not for changes more appropriately targeted at other codes.

1.15. We are now proposing, in line with the scope of the SCR proposals, to include only the three main codes in our Final Proposals for self-governance. Several of the other codes already enjoy varying degrees of self-governance and our decision not to pursue licence modifications does not necessarily preclude suitable code modifications being brought forward to extend the scope of self-governance, or introduce it where it does not already exist.

Assessment of reforms against the Review's Objectives

1.16. In this section, we assess our Final Proposals for SCRs and self-governance 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 SCRs and self-governance processes should provide several important benefits.

Cost-effectiveness and efficient change management

1.17. The SCR process should enable the need for significant code reforms to be considered 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 SCR 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 periods²;
- 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 SCR process; and
- make it more likely that an optimal outcome for consumers would be achieved.

1.18. The introduction of self-governance processes should enable cost savings and efficiencies by reducing the role of Ofgem in modifications with non-material 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.

² It should be noted that it is possible that Ofgem will still need to undertake impact assessments on Path 2 modifications that it considers are important but which do not form the subject of an SCR. Thus, there remains a risk that both industry and Ofgem will have to undertake analysis under the Path 2 process.

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

Proportionality

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

1.21. The SCR process would be highly transparent and would give interested parties several opportunities to influence our thinking through the process. Interested parties subsequently would also be able to raise alternative modification proposals within a defined time period that will correspond with the period allotted for working group consideration of modification proposals.

1.22. Ofgem does not propose to seek a power to modify any SCR-related Directions that it has issued. If events subsequently render an SCR modification proposal inappropriate it can be withdrawn, varied or rejected by the Authority. However, we propose to require a relevant licensee to seek the prior consent of the Authority before withdrawing a modification proposal raised in compliance with an SCR Direction.

1.23. Although we propose to retain existing rights of appeal, it is open to code parties to seek to amend the modification rules in order to require a higher threshold for panel recommendations in the case of SCR-related code modification proposals. It is also open to a relevant panel to recommend an appropriate and proportionate threshold, having regard to the potential costs of introducing an appeal regime in respect of proposals that were broadly supported. The impact of such a change on panel recommendations would depend obviously on the level of the new threshold and on the nature of the SCR.

1.24. We believe that overall, our proposals are proportionate and as noted previously we expect to conduct not more than one or two SCRs per financial year.

1.25. The introduction of self-governance should ensure that Ofgem's involvement in code modifications is proportionate to the issues being raised. We intend to step away from modifications with non-material 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

1.26. Under our SCR proposals, Ofgem is committed to running a highly transparent and inclusive process. SCRs are intended to help ensure that all stakeholder views are taken into account through an open, transparent consultation process in which all parties, including smaller participants and consumers may participate effectively.

1.27. As set out in chapter 2 of the Final Proposals document, the first stage would be to consult stakeholders on whether a particular issue warrants an SCR. Responses to this consultation will be carefully studied by the Authority in deciding whether or not to commence an SCR.

1.28. If we decide to commence an SCR there will be several opportunities for stakeholders to influence the development of our thinking. In addition to publishing consultation documents and IAs, we will be highly likely to organise stakeholder events such as workshops and seminars. The existing code modification arrangements are complex and small participants and consumers find it difficult to engage in code change processes. SCR 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.

1.29. The process of filtering modification proposals should provide transparency benefits by providing information to industry participants on those modifications that have non-material 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.

1.30. We have proposed that code parties, within certain specified time limits, should be free to raise alternative modification proposals after the directed licensee has raised its own SCR-related modification proposal. This proposal is intended to ensure that all parties may put forward their own modification proposals and thus enhance the consultation process.

Rigorous and high quality analysis

1.31. SCRs should improve the analysis undertaken on key strategic areas. This is because the SCR process would provide a holistic approach to considering all the relevant issues, thereby avoiding piecemeal analysis that often arises when these issues are addressed through multiple modifications raised across different time periods. Enabling code parties to raise alternative modification proposals within a given time period is intended to maximise participation without affecting our ability to consider proposals in the round and in a timely way.

Flexible change processes

1.32. The introduction of SCRs 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.

1.33. Our proposals in respect of considering urgent modifications at any time; retaining discretion to allow a non-urgent modification proposal to enter the normal industry code modification process; and subsequently enabling alternative SCR-related modification proposals within the period allotted for workgroup consideration are all intended to promote flexible change processes.

Independent and objective processes

1.34. SCRs should help to ensure that significant code reforms are managed and progressed on 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

1.35. 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 efficiency of the change management processes.

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

1.37. We expect that the SCR process would deliver better policy outcomes in code more quickly, efficiently and effectively than the current arrangements. It would also deliver cost savings in a range of circumstances, including for example where there are significant cross-code issues.

1.38. As we have noted above, we also consider that the SCR process should ensure that the benefits to consumers of significant code changes are not delayed unnecessarily. The impact of improved governance processes on the delivery of significant code modifications is difficult to quantify and is dependent on the nature of the modifications themselves. In previous IAs, we published a case study on electricity cash-out reform to illustrate the potential benefits and savings deriving from the SCR process. We set it out again below.

Electricity cash-out reform case study

1.39. We have assessed the impact of the SCR proposals on costs by reference to past electricity cash-out reform modifications which, in our view, might have been considered within an SCR framework had it existed at the time. We examined both the indirect benefits (to consumers) and the direct savings potentially achievable.

1.40. 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.

1.41. The cash-out arrangements, set out in detail in the BSC, are extremely important to ensure that there is sufficient generation capacity in the market and therefore security of supply. It has proved extremely difficult to achieve co-ordinated and efficient policy development in this area.

Background – electricity cash out modifications under the BSC

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

1.43. 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 that 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.

1.44. 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. Modification P217 was implemented in November 2009. No further proposals have been made to modify electricity cash-out since then.

1.45. An appraisal of current arrangements carried out for Ofgem's Project Discovery has concluded that "short term price signals at times of system stress do not fully reflect the value that customers place on supply security, which may mean that the incentives to make additional peak supplies available and to invest in peaking capacity are not strong enough". Among the five possible policy packages that are being consulted on as part of Project Discovery, improved price signals - including potentially sharpening electricity cash-out - appears in four of them.

1.46. In summary, electricity cash-out has been under continuous review over at least the last six years and it is not clear that all potential improvements to the current arrangements have yet been properly considered. 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. 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. Indeed, the introduction of an SCR 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 SCR process

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

1.48. A further six months might have been required to process and evaluate the resulting implementing modifications. 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 SCR route. We consider there would have been benefits to consumers from having more efficient electricity cash-out arrangements in place several years sooner.

1.49. 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. In July 2009, we stated that it was reasonable to assume that these costs might have been avoided if an SCR had resulted in the implementation in 2005 of a modification like P217. One respondent commented that a single SCR would have been unlikely to have achieved a P217 solution. However, given that the aim of the SCR process is to ensure that all views are considered in a holistic and efficient way, we continue to believe that this is a reasonable assumption and that therefore approximately £100m of costs might have been avoided.

1.50. It has been suggested that P217A meant a simple redistribution of money from "good balancers" to "poor balancers" with no direct savings to customers: there might be cost savings as a result of reduced risk management costs but these would hardly amount to £37m per year. The view was expressed 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".

1.51. 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.

1.52. 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.

1.53. As regards direct savings, under the SCR 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.

1.54. 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.

1.55. 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.

1.56. 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.

1.57. 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.³ 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.

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

Cost savings achieved through self-governance

1.59. We have already set out some of the qualitative efficiency benefits of introducing self-governance. We set out below some analysis of how these benefits can be quantified.

1.60. 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). In July 2009, we stated that it was reasonable to suggest that we would save at least half of the resources we devote to these modifications. We continue to believe that this is a reasonable estimate.

1.61. The back-casting exercise carried out in 2008 suggested that up to half of all modifications might be suitable for the self-governance route. In July 2009, we estimated 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. On that basis, we estimated that the self-governance proposals might save of the order of £125k per year of Ofgem costs.

³ The Brattle Report, June 2008.

1.62. We recognise that several respondents believed that, on the basis of the proposed criteria, we had overestimated the proportion of modification proposals that would be likely to proceed to self-governance. Some respondents considered that around 10-15% of modifications might do so. Ofgem considers that even if this were the case, the benefits in terms of efficiency gains for Ofgem, and code parties would be such as to outweigh the costs of making this change. However, as set out in chapter 2 of the Final Proposals document, we consider that the criterion should change to one of non-materiality rather than triviality. We believe that this may tend to increase the availability of the self-governance route as compared with our initial proposals based on a triviality test.

Impact on consumers

1.63. We consider that our proposals for SCRs and self-governance should provide significant benefits to consumers. We illustrated this above in our case study on electricity cash-out reform. SCRs 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 SCRs that we have already identified above to the extent that these savings are passed through to consumers by suppliers.

1.64. As we have already noted, the piecemeal, complex and resource intensive nature of managing key strategic reforms under the existing code arrangements makes it difficult for small market participants and consumers to engage in these processes. We expect that the introduction of a more holistic, Ofgem led policy-making process, through SCRs, should facilitate engagement from consumers and hence improve policy making with benefits to competition.

Impact on competition

1.65. To the extent that the future SCRs improve policy outcomes and help to ensure the timely delivery of significant code reform, this should be beneficial for competition and the overall functioning of the gas and electricity markets. 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 significant code reform, with consequential benefits to policy making and potentially benefits to competition.

Impact on sustainable development

1.66. The SCR proposals, if implemented may facilitate the implementation of significant code reforms that enable the industry to become more sustainable by reducing carbon dioxide emissions, supporting other environmental improvements, promoting energy savings, tackling fuel poverty or maintaining secure and reliable supplies. To the extent that the proposals, if implemented, ultimately have this

effect, they will be an important contributor to the achievement of sustainable development.

1.67. It is also 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 transmission access reform where smaller generators have found it difficult to engage in the code modification and policy development process.

1.68. We consider that the SCR process 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 strategic 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

1.69. We do not believe that the SCR and self-governance proposals would have any health and safety implications. If a modification proposal was likely to have health and safety impacts it should not enter the self-governance process; if it did, Ofgem would redirect it to Path 2.

Implementation costs

1.70. We do not consider that the up-front costs of implementing our proposals on SCRs will be material. We acknowledge that the relevant licensees will need to make certain allowances to give effect to the modifications to their licenses, which may involve revisions to internal and external documentation together with any associated staff training. However, we consider that the substantive costs will only occur in the event that an SCR is launched.

1.71. As stated in our Final proposals, in the event that we decide to launch an SCR we will publish a statement setting out, amongst other things, an assessment of the impact of conducting the SCR, including estimation of the resource commitment required of Ofgem and the industry. This assessment will properly be made on a case-by-case basis.

1.72. In contrast to SCRs, we recognise that there may be some substantive up front costs to the industry of adopting our proposals for self-governance. The precise level of costs will be entirely dependent on the model the relevant code parties chose to develop and the extent to which existing provisions and panel structures are utilised. The implementation costs associated with any similar modifications to each code may provide a useful benchmark. For instance, we consider that the self-governance

proposals should be similar in both scope and scale to modification P207: "Introduction of a new governance regime to allow a risk based Performance Assurance Framework (PAF) to be utilised and reinforce the effectiveness of the current PAF". The actual cost of implementing this proposal was around £47k in meeting, legal and expert costs plus around 180 'elexon man days' (at £220/day) equating to circa £86.6k⁴.

Risks and unintended consequences

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

SCR risks

1.74. In respect of the SCR process, the major risk is that the new process is not as effective as anticipated. We expect 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 identified with the status quo arrangements.

1.75. 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 in two ways:

- first, where the SCR conclusions are not expressed with sufficient certainty and clarity for industry participants to understand how they could best be implemented through code modifications. It will 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. We intend that any SCR Directions would be expressed as clearly as possible to minimise the risk of misinterpretation. We would then expect the relevant licensee to engage with us promptly if there is any matter on which it is not clear;
- second, where industry participants use the modification process to undermine the outcomes of the SCR. In July 2009, we noted that this could be mitigated by giving Ofgem backstop powers to raise modifications if satisfactory modifications were not put forward. We have decided not to pursue this proposal in light of respondents' views and in the context of other proposals such as the 'send back' powers enabling Ofgem to revert to the relevant code panel if we consider that a final modification report, or the code modification legal text, is in some way deficient and preventing the Authority from making a decision. Ultimately, if we consider that the licensee has not fully discharged the direction given to them, it may be a matter for enforcement action.

⁴ See: '[Elexon Change Report](#)', published March 2009.

1.76. A few respondents expressed doubts over the legality of our SCR proposals and suggested that there was a possibility of successful judicial review of any decision to implement the proposals. We have considered this issue carefully and are clear that we have the necessary powers to seek to implement these changes. We note that of course all our decisions are potentially subject to legal challenge.

1.77. Some respondents stated that we ought to consider the risk that the Government might disagree with Ofgem either on whether an SCR should be commenced or with the conclusions to an SCR. We acknowledge the possibility that Ofgem and the Government might hold different views but would seek to mitigate the risk by keeping DECC well informed of our thinking as it develops throughout the process described in chapter 2 of the Final Proposals document.

Self-governance risks

1.78. 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.

1.79. In the light of respondents' views that a triviality test would mean relatively few modification proposals go to self-governance, we have reconsidered the filtering criteria. Our view is that opting for a materiality test would tend to increase the number of modifications proceeding through self-governance. In terms of minimising the risk of large scale appeals to Ofgem, we suggested a possible interim forum to settle disputes without recourse to Ofgem. We note that this is open to code parties to take up if they wish.

1.80. The second risk 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 non-material implications for consumers, competition or our other statutory duties are progressed through Path 3. 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

1.81. If the SCR and self-governance proposals are implemented it will be important to review the effectiveness of the new arrangements. We therefore propose to undertake a review after three years of operating the new arrangements, should they be implemented. 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.

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

Conclusion

1.83. This impact assessment has attempted to identify the full range of potential impacts, costs and benefits of our proposals for SCRs and self-governance. Our assessment is that the Final Proposals for SCRs and self-governance will make a strong contribution towards improving the efficiency of the codes governance regime.

1.84. We believe that introduction of self-governance will enable Ofgem to concentrate on matters of real significance for energy consumers and will allow code parties to transact non-material modifications more efficiently.

1.85. The electricity cash-out case study concluded that approximately £100m of costs might have been avoided if an SCR had resulted in the implementation in 2005 of a modification like P217. Going forward, we believe that the SCR process will enable Ofgem to lead the industry in a holistic, comprehensive review of the case for significant code reforms and enable any subsequent code modifications to be made in timely and efficient manner. As a consequence, we believe that these proposals will better enable the industry to meet the major challenges facing it, most notably in terms of addressing climate change and maintaining secure energy supplies. This will, we believe, in turn deliver significant and lasting benefits for gas and electricity consumers.

Appendix 9 – Final Impact Assessment - Role of Code Administrators

This appendix sets out an assessment of the impact of our Final Proposals for the role of Code Administrators. It builds on our initial impact assessments and responses we received to the consultations on them. This IA is published pursuant to our duty under the Utilities Act 2000 in relation to IAs.

1.1. We have sought to make an assessment of the various proposals on the basis of their potential to make the operation of the industry codes more efficient and more inclusive, taking account of the Industry Codes Governance Review Objectives. However, assigning a quantitative benefit to such outcomes is generally extremely difficult and so most of the discussion that follows is focused on qualitative assessments.

Role of Code Administrator in code modifications

1.2. One set of potential changes discussed in this document relates to giving the Code Administrator more responsibility for the quality of the analysis carried out in assessing modifications, via the “critical friend” approach. This, in turn, should help to provide rigorous and high quality analysis of the case for and against code changes which is one of the main Review Objectives. Better analysis by the industry should enable industry participants and the Panel to reach a more informed view of the advantages and disadvantages of modifications. This will be particularly important where modifications are handled via a self-governance process. In addition, it should reduce the amount of additional analysis that Ofgem has to carry out when a modification comes to us for a decision and should also reduce the risk of Ofgem having to reject modifications that are submitted to it with deficient or inadequate analysis. We consider this would in turn reduce the potential for modification proposals to be re-raised and hence would provide cost and efficiency benefits. In addition, improved analysis should also enable swifter decision making by Ofgem. This should in turn enable modifications that deliver benefits to be implemented more promptly with consequential benefits for consumers.

1.3. As noted above, there should also be some offsetting reductions in the resources that Ofgem has to devote to code modifications. We estimate that this might be of the order of two full-time employees across all three major commercial codes.

1.4. On this basis, from a purely quantitative perspective and not taking account of the important qualitative benefits we have set out above, we have estimated in the table below the net costs of enhancing the role of Code Administrators to a “critical friend”. The table effectively shows the mid-range, with additional costs being somewhere between £62.5K - £75k/year. However, the worst case scenario, of CA maximum costs and minimum Ofgem savings would produce a net cost of £100k/year. Minimum CA costs and maximum Ofgem savings would produce a net cost of £37.5k/year.

	Min	Max
Code Administrator costs for UNC, BSC and CUSC		
FTE equivalents required	2.25	3
FTE costs (£k/yr)	50.0	50.0
Annual costs (£k/yr)	112.5	150.0
Ofgem savings		
FTE equivalents required	1	1.5
FTE costs (£k/yr)	50.0	75.0
Net Costs (£/yr)	62.5	75.0

Introduction of independent panel chairs

1.5. Whereas we previously consulted on independent chairs of Code Administrators being appointed by the Authority, our Final Proposals require only that the selected individual should be approved by the Authority. In cases where the licensee is satisfied that the prevailing arrangements are consistent with the requirements for an independent chair, no further modifications to the arrangements may be required. This will negate some of the costs associated with our Initial Proposals.

1.6. Notwithstanding that our Final Proposals require only that the Authority approve the selected individual, we have previously set out in our initial Impact Assessments that we considered that ongoing costs of the chair to be similar to those of the incumbent. We did however note that this would depend on the precise role of the chair, which may differ code to code. In principle, there should be very limited net on-going cost resulting from this proposal.

"Send back" powers

1.7. Our initial IA stated that in terms of costs, we did not consider that there would be any material costs associated with the "call in" and "send back" options. Indeed, we consider that the existence of these powers should help to incentivise industry and the Code Administrators to improve the quality and timeliness of their assessments and reduce the likelihood that a proposal is rejected on the basis of technical deficiencies, only to be re-raised. While we have decided not to pursue the "call in" provisions, we do not consider that this will materially change our impact assessment. We consider that the "send back" option will ensure rigorous and high quality analysis as well as increasing cost effectiveness within the codes modification process, while the benefits previously stated for the "call in" provisions will be

delivered through a more rigorous application of existing provisions, such as the Authority's ability to provide views on the CAs proposed timetable for progressing proposals.

Requiring panels to publish the reasoning behind their recommendations

1.8. We remain of the view that there should not be any material on-going costs associated with this requirement, as it would simply be a matter of the Code Administrator collecting and recording the panel members' reasons for decision. In terms of benefits we consider that this proposal should help to ensure rigorous and high quality analysis by providing increasing focus on panel members to explain their reasoning. We also consider that a requirement to publish reasons would enhance transparency. There may be some costs to parties if it is necessary to pursue code modifications to discharge this requirement. However, these costs would in any case be minor.

Introduction of a code of practice

1.9. A code of practice should enable all Code Administrators to be aware of, and adopt, best practice in the various roles they fulfil. Consequently, this should provide benefits in terms of more transparent and easily understood processes as well as promoting inclusive and accessible consultation processes, particularly for consumers and small market participants. If the code of practice contains KPIs, as set out in Chapter 3, this should also help to facilitate effective comparisons on performance across the BSC, CUSC and UNC administrators, potentially promoting cost effectiveness and improved quality of service.

1.10. There would, be both set up costs and on-going costs in managing the code of practice. Due to the work the Code Administrators have already undertaken in producing the draft CoP that we today issued for consultation, we consider that the remaining set up costs would be minimal. However, the CoP should be viewed as a living document, being continually updated as lessons are learnt or circumstances change. On the basis that the CoP has flexible change control, we do not consider that amendments to that document will be materially costly.

Performance evaluation measures

1.11. The benefits of introducing performance evaluation measures should be similar to those associated with introducing a code of practice since their purpose is to improve the way in which the various Code Administrators and more generally the code modification processes work. In other words, there should be benefits in terms of more transparent and easily understood processes and the promotion of inclusive, accessible and effective consultation. A key reason for considering the introduction of performance evaluation measures is that they should increase incentives on the Code Administrators to ensure that they act in an independent and objective

manner. They should also promote the provision of high quality analysis of change proposals as well as cost efficiencies.

1.12. Our Initial Proposals suggested that a “scorecard” should be produced for each Code Administrator once every two years. We considered that the costs to Ofgem of conducting such a survey would be in the order of £70,000. However, our Final Proposals instead propose that the CAs should be subject to a set of common core KPIs on their performance which they monitor and report. These will include quantitative and qualitative measures. We do not anticipate any substantive additional costs to CAs from our Final Proposals and note that some CAs already undertake their own performance monitoring voluntarily.

1.13. We also suggested in our Initial Proposals document that the CAs could be required to achieve and adhere to ISO9001 accreditation. Several respondents questioned our estimated costs of this requirement. In recognition that this accreditation would more appropriately be something Code Administrators voluntarily aspire to, perhaps as a means of differentiating themselves from competitors in the provisions of secretarial services, this does not form part of our Final Proposals.

Small participant, new entrant and consumer initiatives

1.14. All of the options that we have discussed are intended to promote inclusive, accessible and effective consultation for small participants, new entrants and consumers and to ensure that all interested parties are able to fully understand the code governance processes. In addition, the promotion of effective representation of the views of small participants, new entrants and consumers could, if effectively implemented, improve policy making at the codes level and the assessment of code modification proposals with indirect benefits to consumers and/or competition.

1.15. We have today set out draft licence modifications which will ensure that Consumer Focus will have a seat with voting rights on the UNC panel, bringing it into line with the CUSC and BSC. We recognise that fulfilling this role may place a resource burden upon Consumer Focus. We anticipate that the staffing requirement for participation on each of the three main panels, including attendance and preparation would take up around 3-9 working days per month, or no more than £20k/year. We consider that this cost would be justified and outweighed by the benefits of having a greater consumer perspective on industry code proposals.

1.16. We have also proposed that the Code Administrators have obligations to engage with small participants, new entrants and consumer representatives at the same time as, but outside of, the modification group process. Depending on how the CAs choose to discharge these obligations, it is possible that additional code administration staff will be required. Our initial IA assumed that around one full time employee would be required per code, which would equate to around £150k/year.

1.17. We again consider that these costs would be outweighed by the improvements that will be made to the modification process and the earlier realisation of benefits

from subsequent proposals. We also consider that the CA will have a degree of discretion on how they seek to discharge these obligations and adhere to the principles of the CoP, which may reasonably differ across codes proportionate with the resources of the CA.

Impact on Consumers

1.18. We have assessed above, in general terms, the benefit and cost implications of the various options that we have set out in this document, having particular regard to the Review Objectives.

1.19. The key benefits to consumers associated with the options set out above are in two categories, namely the benefits to:

- those consumers and consumer groups who engage directly in the modification process through transparency, accessibility, and inclusivity; and
- consumers generally. We consider that by helping small market participants and new entrants to engage in the codes process this should indirectly facilitate competition. In particular, the changes set out in this document should help smaller participants and new entrants engage in, understand and influence the codes modification process. Ultimately, making the regulatory framework more transparent and accessible should benefit competition. In addition, there is also the possibility that the changes that have been proposed should help small participants and new entrants raise code modification proposals that provide benefits to consumers. Further, by improving the quality of analysis that is undertaken and the efficiencies of the code modification process, this should also indirectly ensure that modification decisions that benefit consumers are made faster than is currently the case.

1.20. It is important to note that many of the proposals would incur costs that would ultimately be borne by consumers. We consider that for the proposals we have set out in this document these costs are likely to be minimal.

Impact on Competition

1.21. As we have discussed above in the section on consumer impacts, we consider that the improvements in the governance process should help facilitate engagement from small market participants and new entrants in the codes modification process. We consider that increased transparency in the code change process should help facilitate understanding of the regulatory arrangements. Many small participants and new entrants have limited resources compared to the larger incumbent energy businesses and therefore struggle to engage in reform in key policy areas. By helping small participants and new entrants to engage, this should indirectly help to generate pro-competitive policy proposals, with consequential benefits to policy making and potentially benefits to competition.

Impact on Sustainable Development

1.22. It is important to note that many of the smaller participants that 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).

1.23. We consider that the introduction of policies to improve engagement and participation from small parties and new entrants such as renewable generators might provide consequential benefits in terms of policy development in the sustainable development area.

Impact on Health and Safety

1.24. We do not foresee any impacts on Health and Safety as a result of these proposals.

Risks and Unintended Consequences

1.25. We consider the key risk to be that the changes proposed do not deliver their intended benefits and that consumer/small participant engagement does not increase as a result of any changes that are implemented. A particular risk is that the roles and responsibilities of Code Administrators are expanded with an associated increase in costs, without commensurate benefits.

1.26. We consider that this risk is ameliorated to a large extent by the fluid nature of the Code of Practice and the fact that it is a principle-based approach rather than prescribing a de facto minimum standard. In conjunction with the KPI reporting, this will allow Code Administrators and interested parties to evolve the code modification procedures. Code Administrators will be expected to tailor their approach to address any concerns coming to light. Equally, they should be able remove points of process which appear to be redundant or of little value.

Post-implementation review

1.27. Given the intent of creating a fluid set of governance arrangements which may be influenced by interested parties and modified to address issues as they arise, we do not consider that there should be a need to conduct a post-implementation review of our proposals for the role of code administrators, per se. However, as we have previously set out, for instance in our decision on the scope of the Codes Governance review, if these initiatives prove to be insufficient to address the identified weaknesses in the arrangements, we may re-consider some of the more structural reforms suggested in our earlier consultations, but ruled out of scope for this particular review.

1.28. One specific aspect of our proposals that could be subject to future review is the selection and approval of independent chairs. We have indicated in our Final Proposals that this is something that may be looked at once the process has bedded into practice, in particular if the Authority has had cause to veto the candidate selected by the relevant panel. Equally, assuming the panel selections prove to be robust, it may be apt to consider whether the enduring provisions around the Authority appointing the BSC chair remain appropriate.

Conclusions

1.29. This IA has attempted to identify the full range of potential impacts, costs and benefits of our proposals for the Role of Code Administrators. We consider that many of the initiatives outlined in these proposals can and will be delivered with little more than a change to custom and practice.

1.1. We consider that the true measure of these proposals will be in the improved efficiency of the modification process as a whole, with proposals being progressed through to decision and implementation in a more robust and timely fashion, with fewer rejections and iterative modifications. Ultimately, this will allow the benefits of future proposals to be realised sooner.

Appendix 10 – Final Impact Assessment - Governance of Charging Methodologies

This Appendix builds upon the initial Impact Assessment previously published as part of our December and July documents, taking into account feedback received from respondents and revisions made to our Final Proposals. This IA is published pursuant to our duty under the Utilities Act 2000 in relation to IAs.

Background

1.1. The charging methodologies⁵ developed by the network operators (NWOs) have impacts on both the siting and operational decisions of market players as well as having significant distributional effects. We therefore considered whether all network users and consumers should be allowed to propose changes to these methodologies.

1.2. Our September 2008 document set out a number of governance options for charging methodologies that included allowing non-network parties to propose modifications to the NWOs' charging methodologies. These were:

- 1. Maintain the status quo.** Under this option, the existing arrangements under which only the NWOs can raise changes to the charging methodologies would be retained; though this would not preclude the NWOs from making improvements along the lines of established best practice.
- 2. Modify the current licence regime.** Under this option, network licences would be modified to enable network users (and customer representatives) to raise modifications to the charging methodologies. The NWOs would be required to assess and consult on these proposals and ultimately submit them to the Authority for decision.
- 3. Industry Code Governance.** Under this option, the charging methodologies would be transferred into the relevant industry codes. Parties to the industry codes would be able to raise changes. The changes would then be assessed by the relevant code panel and submitted to the Authority for decision. Parties would have the ability to appeal Authority decisions on such modifications to the Competition Commission where the Authority decision diverged from the panel recommendation.
- 4. New charging methodology change management code.** Under this option, a new code would be created containing the rules and procedures by which the charging methodologies of each NWO would be modified (by both NWOs and industry participants). Each NWO would be required to sign up to the code.

⁵ Connection charging methodologies and Use of System (UoS) charging methodologies.

1.3. We undertook an initial assessment of the governance options against the objectives of the Review and found that there may be advantages to changing the governance arrangements, particularly in terms of improving accessibility and transparency. There may also be benefits in terms of accountability, as NWOs may be required to provide greater rationale for favouring one methodology over suggested alternatives. In particular, opening up the charging methodologies should enable network users and customers to bring forward innovative changes and address deficiencies in the existing methodologies.

1.4. Notwithstanding the important benefits associated with opening up the methodologies, there are also risks and costs. Given the distributional impact of network charges on market participants, there are risks that market participants will raise significant numbers of modification proposals to change the methodologies. In turn, this creates a number of possible effects including increased change administration costs, increased regulatory uncertainty and potential for pricing volatility risks.

1.5. Respondents to our September 2008 document felt that a more in depth cost benefit analysis needed to be undertaken in light of the potential risks already identified.

1.6. Therefore, in our August 2009 consultation document we presented an impact assessment (IA) which assessed the cost and benefits of enabling non-network parties to propose modifications to the charging methodologies. The IA sought to quantify the cost and benefits of each of the proposed governance options and to provide an indication of whether there was a particular option where the benefits outweighed the costs. In addition, the IA also sought to determine the qualitative cost and benefits of the proposals.

Final Proposals

1.7. We are proposing to make the network charging methodologies subject to industry code governance. We are proposing that the electricity transmission UoS and connection methodologies will sit in the CUSC and the same methodologies for gas transmission to sit within the UNC.

1.8. We further propose that the gas distribution UoS charging methodology should also sit within the UNC. Given the issues discussed in Chapter 4 of our Final Proposals, we will give further consideration to the governance of the gas and electricity distribution connection charging methodologies and therefore exclude these from our Final Proposals. The electricity distribution use of system charging methodology is proposed to be inserted into the Distribution Connection and Use of System Agreement (DCUSA) as part of the Structure of Electricity Distribution Charges project and has not been considered further here.

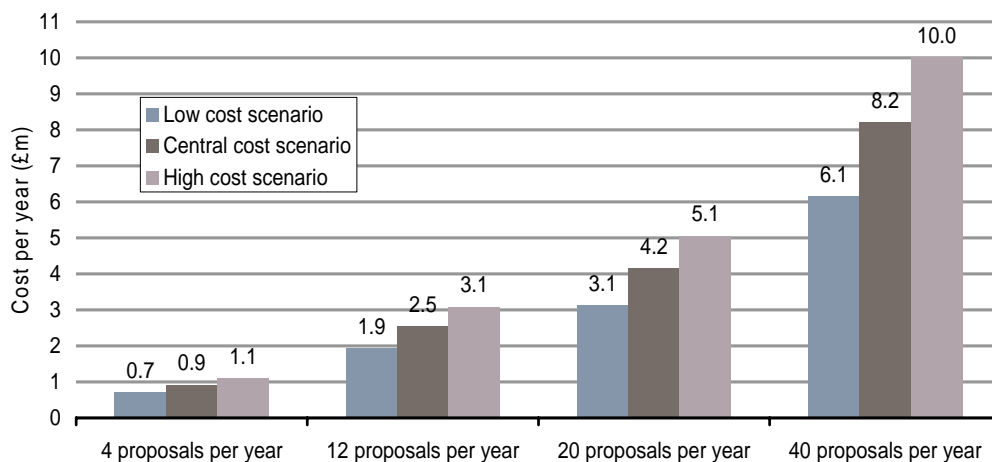
Quantitative Analysis

Costs

1.9. The IA was able to quantify the cost associated with a change from the current governance arrangements based on the potential increase in the number of proposals being presented and the costs associated with the assessment of these proposals.

1.10. The diagram below shows the low, central and high cost scenarios in relation to assessment and implementation costs associated with additional proposals.

Total forecast assessment/implementation costs associated with additional modification proposals



1.11. The basis of these costs was provided by the network operators and network users. We believe these costs scenarios remain valid and have taken these into consideration in our Final Proposals.

1.12. We sought views on our IA in our August consultation document. We asked whether the industry agreed with the output from the assumption made in the quantitative analysis. Of the 13 responses received nine respondents were in general support of the analysis. These respondents felt that the analysis was credible and the assumptions appear to be appropriate noting that it was difficult to anticipate the number of modifications that could be proposed. One respondent felt that the costs for each of the options were overstated.

1.13. The remainder of respondents felt that some extra analysis should have been undertaken to give the analysis more credibility. One respondent felt that the analysis was too simplistic and another felt that there could have been some analysis

of the historical modification proposed, implemented and a review of any underlying trends.

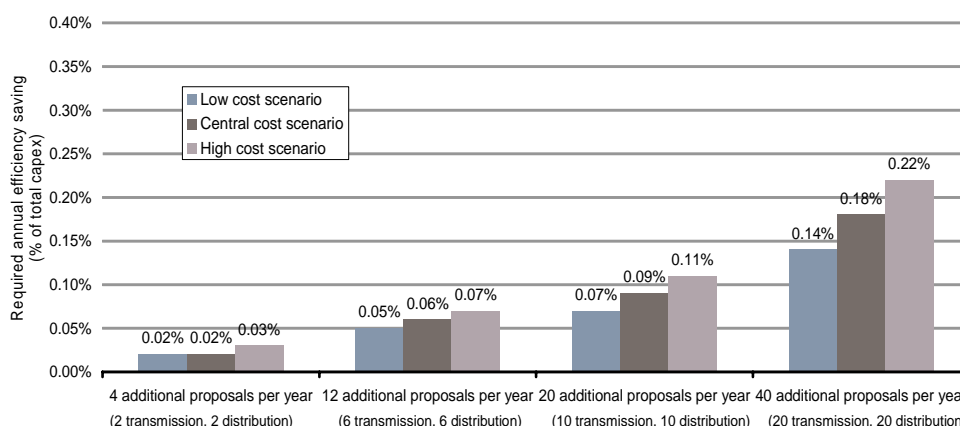
1.14. We note that our Final Proposals may lead to additional costs and that the level of these costs will be dependent on the throughput of modification proposals. However, in relation to the potential level of investment in the transmission network we believe these costs are relatively modest.

Benefits

1.15. The quantitative analysis also sought to quantify the benefits of the proposed governance arrangements. As the benefits are mainly qualitative in nature it was noted that it is difficult to quantify these. However, given the potential capital investment in the networks expected over the medium and long term it was assumed that the new governance arrangements could lead to the network operators making efficiency savings in terms of reduced capital expenditure.

1.16. The industry provided some information that underpinned a number of the cost assumptions used in the analysis. Based on information provided by NWOs on their assessment and implementation processes and the number of FTE involved in both processes a cost per modification could be derived. An electricity transmission modification would cost approximately £63,000 to assess and implement however, these costs are lower for a gas transmission modification - approximately £32,000. For gas distribution, the information provided by two GDNs differed quite widely with cost per modification ranging from £18,000 to £40,000 in terms of assessment and implementation. Therefore to provide a full range of potential costs a number of cost scenarios were produced based on throughput of proposals and cost ranges. The diagram below depicts the required savings across the various cost scenarios.

Required annual efficiency savings as a percentage of total capex in each year



1.17. The quantitative analysis also considered the necessary annual efficiency savings should the new governance arrangements be rolled out in transmission first. The analysis showed that the required savings are a little higher than those for the wider industry however given the proposed level of capital investment in the networks the required savings are modest.

1.18. We remain of the view that all charging methodologies should be subject to open governance arrangements and that revised arrangements could accrue a number of benefits. In Chapter 4 of the accompanying Final Proposals document we have indicated that we do not propose to include the distribution connection charging methodologies in the revised governance at this time and discuss the reasons for that position. We do not believe that the exclusion of distribution connection charging methodologies will have a material impact on the assessment of the governance arrangements that had been proposed.

Qualitative Analysis

1.19. In our August 2009, consultation we undertook a detailed qualitative analysis of the governance options and found that our proposals would have a positive impact on consumers, sustainable development and competition. We have not changed our previous assessment against these criteria and as such we do not intend to repeat it here.

1.20. However as we propose to implement our Option 3 proposal for connection and UoS charging methodologies within transmission and UoS methodologies in gas distribution it may serve to briefly reassess this position against the qualitative criteria in our August document.

Impact on Consumers

1.21. As previously stated we believe that Option 3 will provide a number of benefits over those provided by our Option 2 and Option 4 proposals. The main benefits are:

- the utilisation of existing code governance arrangements – this will provide some efficiency savings that may be otherwise lost if a new code had to be developed.
- Support from an independent Code Administrator – designated parties that are not familiar with the code processes can obtain assistance from an independent Code Administrator.
- Parties can challenge an Authority decision, where this is different from the relevant Panel's recommendation, by referring it to the Competition Commission.

1.22. These benefits will have a positive impact on consumers in a number of ways. Using established code arrangements will reduce the cost to industry parties in obtaining additional resources to bring a new code into effect where ultimately, these costs are recovered from the end consumer. Consumer representatives, where we deem this to be appropriate, will be able to propose modifications to the charging methodologies. Although, in some instances they may not be familiar with the code

processes as part of the wider Code Governance Review we intend to require the Code Administrators to assist parties who requires some help.

1.23. Finally, customers and users can challenge the Authority decision to the Competition Commission where this is different to the Panel's recommendation. We consider that this additional challenge mechanism will provide some comfort that the Authority decision may be further scrutinised by an independent party.

1.24. We have indicated that subjecting the NWOs' charging methodologies to open governance could lead to an increase in administrative and assessment costs. Some of these costs will ultimately be borne by consumers.

1.25. We believe that Option 3 will provide the most robust and efficient governance arrangements that will enable non-network parties and consumers (and their representatives) to propose modifications to the NWOs' charging methodologies. This governance arrangement will (as far as possible) ensure that sufficient assessment and analysis of charging methodology modification proposals is undertaken in the most inclusive manner with the appropriate checks and balances.

1.26. Therefore we believe that, on balance adopting Option 3 will have a positive impact on consumers.

Impact on sustainable development

1.27. We have previously issued guidance to the industry code panels on how to ensure that sustainable development issues are fully considered throughout the development of code modification proposals.

1.28. Option 3 would enable renewable interests such as renewable generators and suppliers who source electricity from renewable generation, to raise modification proposals which are intended to secure sustainable development benefits. In particular, this governance arrangement should help to facilitate the engagement of environmental interests that should further assist in promoting a low carbon economy.

1.29. To the extent that allowing non-NWO parties to formally raise modification proposals leads to more cost reflective charging methodologies being proposed and approved, this should in turn lead to more efficient siting and operating decisions by network users and result in reduced capex on network infrastructure.

1.30. As such, for the reasons set out above, we believe that our Option 3 governance arrangement could have a positive impact on sustainable development.

Impact on competition

1.31. As stated above having the charging methodologies sitting in code will promote transparency and accessibility. This will allow interested parties to raise proposals. There will be benefits to the competitive sectors from this change, to the extent that, allowing a wider group of parties to raise proposals will lead to proposals that further promote competition. We consider that having a wider base of parties raising proposals is likely to lead to more innovative charging proposals that ultimately may improve competition.

Impacts on health and safety

1.32. We have not identified any impacts on health and safety associated with the charging methodology governance proposals.

Risks and unintended consequences

1.33. From the outset our proposals identified a number of risks. These risks related to the increased administrative burden that may materialise due to the increased volume of modification proposals being presented. Our quantitative analysis showed that with increased volume of proposals there will be increased costs. In addition, there was a risk that allowing non-NWO parties to formally propose modifications could lead to vexatious and spurious proposals having to be assessed and progressed through the change procedure therefore adding to the cost burden.

1.34. The other risk identified was that open governance would undermine price certainty and have a negative impact on the NWOs' allowed revenue recovery.

1.35. To address these concerns we have proposed a change window. While we agree that a change window, will not in itself reduce the number of modifications being proposed we remain of the view that a robust modification management procedure should be adopted as we expect that such a procedure should go some way to enable NWOs to manage proposals effectively and rationalise them where appropriate.

1.36. We consider that the volume of modifications will be self-policing to an extent due to the administrative burden of raising proposals and the need to justify their merits based on available information on NWOs' costs and methods. It is likely that parties will have proposal ideas but these will need to be fleshed out in conjunction with the network operator and relevant charging forums.

1.37. The code governance change procedure requires that a proposal must seek to further the relevant objectives and set out the issue that needs to be rectified. Further the use of development groups and/or charging methodology forums will allow further development of any proposal that may lead to proposals being withdrawn if they are not fit for purpose.

Post Implementation Review

1.38. Our proposals introduce a new governance arrangement for the modification of NWO charging methodologies. Until these processes are tested it will be difficult to assess the integrity and the effectiveness of the process. Therefore we propose to undertake a review after a sufficient number of modifications have been through the process.

1.39. The review will consider the nature and number of proposals, the efficiency and effectiveness of code process, and review the number of proposals raised by non-network parties.

Conclusion

1.40. The IA indicated that there would be increased costs that would be outweighed by modest capex savings. We believe that the code governance arrangements will provide the most suitable arrangement to enable non-network parties to propose charging methodology modifications.