



Abid Sheik
Ofgem
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27 September 2010

Dear Abid,

Re: Open Letter Consultation—Potential Significant Code Reviews

Headline points

We support the principle of significant code reviews (SCRs) as a route to implement changes to industry processes in a holistic manner, especially where the industry establishes a track record of not working towards necessary change **and/or** where issues straddle different codes.

Of the three possible reviews canvassed by Ofgem, we think electricity cash-out is the priority and meets the tests. We believe the other issues identified, while in need of more focussed attention, can and should be progressed under existing governance structures.

However we do have some concerns arising from the Ofgem letter on the approach to identifying appropriate SCRs. We note:

- the potential scale of the work implied, especially if this sort of open consultation is to become some form of annual “bidding round”;
- if it **is** assumed that the regulator will routinely initiate review on significant code matters based on active solicitation, there is a danger that the regulator could become or be seen as a sectoral design authority;
- in turn this could disincentivise code administrators for progressing matters that should fall within their jurisdictions; and
- there are also real question-marks over the ability of many stakeholders except for the largest to adequately engage in lengthy SCR review processes, especially given the high level of regulatory activity that already exists, and Ofgem needs to consider how to ensure mechanisms can be put in place to enable smaller participants to properly engage in review processes.

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This is a response to Ofgem’s open letter dated 12 August. We have comments on the process and the proposals for SCR, including your views on the scope and scale of any reviews.

Process

We would not expect the current consultative process to establish a precedent for future years. Reviews should ordinarily be initiated by reference to much more clearly defined criteria and to demonstrable failure of code governance to address issues as part of normal development processes. In particular we need to avoid an outcome whereby this sort of open consultation—either through an open letter or the Corporate Plan process as proposed for future years—is to become some form of annual “bidding round”. If it is assumed that the regulator will routinely initiate review on significant code matters where it believes industry change processes have fallen short and based on active solicitation, there is a danger that the regulator could become or be seen as a sectoral design authority.

The SCR really should be a last resort. However, we are concerned that over the life of the code governance review the purpose of the SCR has been subtly redefined. There are clear indications in the 12 August letter that the SCR is no longer regarded as a default mechanism where governance processes fail; rather it is a mechanism for Ofgem translating its vision of market rules into practical effect. In turn this reemphasis could disincentivise code administrators—who tend to be change averse—from progressing matters that should fall more properly within their jurisdiction.

In this context thought should also be given to how the Government’s policy directions and the SCR process complement each other. In a separate submission to DECC, in response to its call for evidence as part of its review of Ofgem available [here](#), we have highlighted the need for more focussed direction from the Government on its desired outcomes from the economic regulatory regime. Therefore the regulator may want to review its approach to selection of SCRs in the light of the ongoing review of its role.

Although formal SCRs powers are only now being introduced, in effect Ofgem has already attempted to undertake major reviews over the past couple of years. These have covered the code governance review itself, the transmission access review and the RPI-X@20 programme of work. These work-streams have invariably required significant resource from the industry as well as Ofgem, and they have all taken substantially longer than a year to complete from start to finish. That said it is more than semantics, but a review lasting nine months (as proposed in two of the three proposed cases) would not be a “short review”.

These reviews have already proved very difficult for smaller participants to track and actively engage in. Some might say that having a formal SCR mechanism is a necessary evil as it will place a clearly defined process around review initiatives that would probably have occurred anyway. But that process needs to be sense-checked to ensure timely and efficiency engagement of those with limited resources, and the initiation letters need to specifically address this matter.

A post implementation audit should be carried out routinely by Ofgem to assimilate learning points once an SCR has been concluded.

Proposed SCRs

Turning to Ofgem’s shopping list, electricity cash-out is an issue that does require urgent attention under an SCR. We believe the other issues flagged, while there is merit in review, can and should be addressed under existing governance structures.

Electricity cash-out

Despite efforts over the last six years (at least) to improve the cash-out mechanism, culminating in the Authority’s approval of P217A, it is still too complex, and cash-out prices probably remain polluted and not cost-reflective. Cash-out needs a route-and-branch overhaul as it typifies many things that is misaligned about the current electricity trading arrangements—it is impenetrable to all but a few; it loads costs through artificial and complex rules, and the prices based on an artificially wide spread cannot be forecast or hedged. It is also a

prime candidate for the SCR process because of the interactions between energy and system imbalance and thus between the BSC, CUSC and the transmission licence.

In our view the first stage should be to develop a set of coherent design principles for electricity cash-out that takes into account the distributional effects of the current mechanism on different participant classes and technologies. The objective of simply creating incentives to balance simply does not make sense against wider energy policy goals, including the stated desire by DECC to remove barriers to entry, and the Government should be invited to set out a view on desirable outcomes as part of its work on market reform. There then needs to be a dispassionate critique of whether these objectives have been met under current trading structures. Interactions—or rather the lack of any—with the traded markets also need to be addressed as the differential ability of parties to avoid cash-out on fair terms is a major failings of the current electricity market design.

The issues flagged in the P217 decision letter are important, and need to be embraced within the review. This noted: “We do not consider that [P217A] addresses all of the issues with the current cash-out arrangement ... there remains scope for improving the arrangements further. For example, we believe that the issues surrounding targeting of reserve costs, cash-out price spread and timing of gate closure and contract notifications may warrant further consideration in any future modification proposals.” However we believe these issues and those flagged by the open letter are subordinate to the higher-level issues about the purpose and effect of cash-out and the defects identified above. Consequently it is doubtful whether a proportionate review could be concluded, as proposed, within nine months.

Gas cash-out

It is not clear why this matter cannot be progressed by a UNC review group, though Ofgem itself clearly needs to consider possible interactions between electricity and gas given the high levels of gas-fired plant that can be exposed to both sets of imbalance arrangements. However, this latter issue of itself does not warrant a SCR as such, and there is no reason why Ofgem cannot sponsor its own work in this area if it wishes to stimulate thought.

Smart metering

Smart metering undoubtedly has far reaching impacts on wider industry processes. As the current proposal is to establish a smart metering governance code covering gas and electricity markets, it is not clear if the development of this would comfortably sit within or without the SCR. Further it is for consideration whether it would be sensible to take forward the SCR until the Smart Metering Implementation Plan (SMIP) has progressed further or until the smart metering code is more fully developed.

Indeed many of the issues flagged in the open letter and accompanying annex probably should have been addressed as part of the various impact assessments that have been carried out to date or logically fall initially under the SMIP. As for the use of interval data in settlements, this should be addressed urgently but separately within the BSC environment, and we can see no reason why Ofgem cannot ask for existing governance to take this forward—it is separately conducting a review of metering services and Elexon also has under away its Profile and Settlement Review Group, so there are no shortage of avenues.


If there is to be a review in this area we would also recommend that the review considers access to metering agency services, particularly for independent market participants, with a view to placing licence obligations on ex-PES suppliers to underpin fair access to in-house services. But we see this primarily as a licensing issue rather than one falling under the jurisdiction of existing codes, and it would be wrong to use the SCR mechanism as a catch-all or a mechanism to deliver a particular regulatory wish-list.

We would make some further observations on the process moving forward.

Transmission charging arrangements

While there is much amiss with current transmission charging structures and with current change proposals in process, they do not by definition at present fall under code jurisdiction. Given a regulatory review is already underway, we would want to see an orderly and predictable review process. But at this stage the issue cannot fall under the SCR process and should not until normal governance has had some opportunity to work.

Yours sincerely,

A handwritten signature in blue ink that reads "Nigel Cornwall". The signature is written in a cursive style and is positioned above a horizontal line that extends to the right.

Nigel Cornwall