



Industry participants, customers
and other interested parties

*Promoting choice and value for
all gas and electricity customers*

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Date: 12 August 2010

Dear Colleague,

Open letter consultation: Potential Significant Code Reviews (SCRs)

Purpose of this letter

This letter seeks stakeholders' views on the issues that we consider should be addressed at the earliest opportunity through a Significant Code Review process and sets out our initial views on the need, scope and scale of these reviews.

We committed to consult with industry on possible SCRs in advance of any launch. This was reinforced in our 2010/2011 Corporate Plan deliverable to consult with relevant stakeholders on potential SCR initiatives. This letter is intended to meet these commitments. In future years, we intend to consult on potential SCRs through the Corporate Plan.

The Code Governance Review final proposals and the subsequent licence changes¹ introduced a new regulatory mechanism within the industry codes². This mechanism, the Significant Code Review, is designed to facilitate complex and significant changes to these industry codes. It provides a role for Ofgem to undertake a holistic review of a code based issue and speed up industry reform. Following the introduction of the licence changes on 5 July 2010, National Grid and the industry are working to introduce the new arrangements into the relevant codes and this work will be completed by the end of December 2010.

There are three areas that we consider are priorities and that may be appropriately addressed through a SCR. These areas reflect commitments already made in the 2010-15 Corporate Plan³ and are consistent with the Government's high-level policy framework. They are:

- 1) Electricity cash-out: following the Authority's approval of BSC modification P217A⁴, we committed to undertaking a review of electricity cash out in November 2010 to better understand the effects of this modification and determine whether further changes were necessary. We also recognised that there may still be issues with the

¹ The final proposals and statutory licence changes are on the Ofgem website:
<http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>.

² The industry codes affected are the Balancing and Settlement Code (BSC), the Connection and Use of System Code (CUSC) and the Uniform Network Code (UNC).

³ The Plan appears on the Ofgem website:
<http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/Corporate%20Strategy%20and%20Plan%202010-2015.pdf>.

⁴ The P217A decision letter: <http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCCode/BSC/Documents1/P217D.pdf>.

current cash-out arrangements as part of our work on Project Discovery⁵. Any conclusions from such a review will impact on the BSC and we consider are best developed through a SCR.

- 2) Gas security of supply: as part of our follow-up to Project Discovery we have initiated further work related to the gas emergency cash-out arrangements. Among various options, we intend to investigate the case for more dynamic cash-out prices at stage 2 of an emergency, as well as review the current compensation arrangements in place for firm load disconnection. We may also wish to explore potential reforms to the gas cash-out arrangements outside an emergency. As we indicated when we approved modification UNC260⁶, this is an important and urgent area for review. The scope of this work may ultimately involve changes to the UNC.
- 3) Smart metering impact on wider industry processes: gas and electricity smart meters are already being deployed to in the domestic market. The Government's decision to mandate the roll out of smart meters will accelerate this process. This will put pressure on certain industry processes, in particular settlement arrangements, and also create opportunities to improve them to the benefit of the industry and consumers. We consider that the SCR process can be used to develop, where appropriate, wider code changes (to UNC and BSC for instance) in parallel with the work of the Smart Metering Implementation Programme.

These three issues are not new and we have previously indicated through our Corporate Plan that they are a priority for us. However, we welcome your views on the issues raised in this letter, in particular on whether you consider that the issues are appropriate for addressing through a SCR. More details on each issue are also set out in Annex 1.

Lastly, we are currently considering whether the transmission charging arrangements need to be reviewed through a SCR. The governance of network charging methodologies is changing and, from the end of the year, change will be governed through the industry codes. Given the preliminary nature of our thinking in this area this letter does not consult on whether it is an appropriate area to be developed through a SCR. If we consider that it is appropriate to undertake a review we will consult separately.

Background to Significant Code Reviews

SCRs are a key outcome of our recently completed review of the governance arrangements for industry codes, the Code Governance Review, for which final proposals were issued on 31 March 2010.

Introducing the SCR process will provide a holistic approach to developing and making code changes in areas of complex reform of a technical nature. Given the challenges facing the energy industry, we consider that it is critical that significant code changes can be facilitated more quickly and effectively. Under this approach Ofgem will play a leading role in facilitating code changes through the review process, avoiding many of the pitfalls of piecemeal reform of codes, which can be ineffective and inefficient in delivering change.

We have modified the licences which relate to the main commercial codes, namely the BSC, the CUSC and the UNC to allow the Authority to direct the relevant licensee to raise a modification proposal(s) that brings the conclusions of a SCR into effect. We do not consider that this precludes a SCR from appropriately considering the impacts of the issue on any other codes, or indeed reaching any conclusions on the modifications which may be necessary to those codes in order to give full effect to the SCR conclusions. However, the Authority has taken no formal licence power to direct that SCR-related modifications to other codes are raised.

⁵ Details about Project Discovery appear on our website:

<http://www.ofgem.gov.uk/Markets/WhlMkts/Discovery/Pages/ProjectDiscovery.aspx>

⁶ UNC260 decision letter: <http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC260D.pdf>.

The selection of SCRs

The criteria against which Ofgem will decide whether to initiate a SCR are that:

- an issue could be given effect wholly or mainly through modification of the relevant industry codes;
- the Authority considers the issue to be of significance in relation to its principal objective and/or statutory duties and functions or obligations arising under EU law and in particular:
 - it is likely to have **significant impacts on gas and electricity consumers or on competition** (this may be a qualitative assessment); and/or
 - it is likely to have **significant impacts on the environment, sustainable development or security of supply**; and
- an issue is likely to create significant cross-code or code-licence issues.

We stated in our Code Governance Review final proposals that we envisage that, in a typical year, Ofgem would initiate only one or two SCRs. We therefore need a robust process for prioritising potential SCRs to ensure the most efficient outcome and use of Ofgem and industry resources.

SCR proposed issues

We have set out in Annex 1 each of the three issues that we have identified as being immediate candidates for a SCR. At this stage, we have not included great detail on each of the issues which we consider may merit development through a SCR. Many of these are already familiar to the industry and have been well documented. Instead, this letter concentrates on why we consider these issues may, or may not, be suitably addressed through a SCR commencing during 2010/2011.

Electricity Cash-Out

Perceived need: As part of our decision letter on P217A⁷ we made a commitment that we would undertake a post implementation review after 12 months to understand the impact that this modification has had on cash-out prices and to establish whether further change was necessary. P217A was the latest in a series of changes that have been made to electricity cash-out arrangements. Separately, through our Project Discovery work we identified a number of issues with the current market arrangements which, if not addressed, may impact on security of supply. We considered that short term price signals at times of system stress do not fully reflect the value that customers place on supply security. This means that the incentives to make additional peak energy supplies available and to invest in peaking capacity are not strong enough. We consider that this issue will become more acute with the challenges of the coming decade.

Proposed scope: In the electricity markets we consider that the charges placed upon out of balance parties may not accurately reflect the costs of actions taken by the System Operator (SO) to balance the system. We consider that this is increasingly important as we move to a system where there is growing penetration from renewable energy, as strong signals to the market will be needed to react to increasing fluctuations in supply from this less predictable generation. The electricity cash-out arrangements are set out in the BSC and any conclusions are likely to involve modifications to the BSC. This review would cover the commitment we made to review P217A.

Scale and timescale: We expect to build on existing work that has been undertaken and which is ongoing. Subject to responses to this consultation, we would expect to launch this as an SCR at the end of this year. We expect that a short review period is appropriate

⁷ See footnote 4 above.

given the expected scope of the review and the work ongoing. We consider that a review period of up to 9 months is appropriate. This would involve a series of workshops, meetings and consultations. We expect that we would produce initial findings and then follow this with more detailed final conclusions and potential direction to the licensee to make code changes.

SCR route: This review will focus on the cash-out arrangements. These are currently provided for in the BSC. We consider that these arrangements and any changes to them have the potential to have a significant impact on electricity security of supply. Given this we consider that a SCR is the appropriate mechanism to develop our thinking to address our current concerns.

The Government is currently conducting a detailed appraisal of the way the electricity market should be designed, which could have significant implications for the design and functioning of the cash-out arrangements in GB. In determining the scope and timing of any SCR in this area, Ofgem would need to have regard to the progress of this appraisal, which is expected to be the subject of a government consultation in Autumn 2010.

Gas Security of Supply

Perceived need: As part of our Project Discovery work we identified a number of issues with the current market arrangements related to gas security of supply. In particular we noted that short term price signals at times of system stress do not fully reflect the value that customers place on supply security. This means that the incentives to make additional peak energy supplies available and to invest in peaking capacity may not be strong enough. We consider that this issue will become more acute with the challenges of the coming decade.

Proposed scope: We consider that this problem primarily manifests itself in the gas emergency cash-out arrangements although there may be other aspects of the current arrangements that need to be considered. Our review on this area may include implementation of a dynamic cash-out price in a gas deficit emergency (more reflective of market conditions), changes to the role of the network emergency coordinator (NEC), and compensation at the value of lost load (VoLL) for firm customers who are disconnected. The cash-out arrangements are set out in the UNC and any conclusions are likely to involve modifications to the UNC.

Scale and timescale: We expect to build on existing work that has been undertaken and is ongoing. Subject to responses to this consultation, we would launch this as a SCR at the end of this year. We consider that a short review period would be appropriate particularly given the work that is currently ongoing. We expect the review to last a period of 6 to 8 months. This would involve a series of workshops, meetings and consultations. We expect that we would produce initial findings and then follow this with more detailed final conclusions and potential direction to the licensee to make code changes.

SCR route: A large part of this review will focus on the emergency cash-out arrangements and these are currently provided for in the UNC. We consider that these arrangements and any changes to them will have a significant impact on gas security of supply. We consider that a SCR is the appropriate mechanism to develop our thinking to address our current concerns.

Smart metering impact on wider industry processes

Perceived need: As set out in the recent Prospectus⁸ published by the Smart Metering Implementation Programme, the introduction of smart metering will put pressure on and enable significant improvements to a range of industry processes, including settlement

⁸ The Smart Metering Prospectus published jointly by DECC and Ofgem appears at: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=40&refer=e-serve/sm/Documentation>.

arrangements. There is a need to undertake a thorough review of the wider industry processes to consider whether reforms are needed to ensure the full benefits of smart metering are realised. Smart meters will provide a number of opportunities for suppliers to improve the customer experience and also to allow customers to play their part in a low carbon economy. However a number of changes may be required to existing systems and processes to facilitate this, including enabling suppliers to settle more customers using actual readings rather than profiles. While we acknowledge that the industry can drive forward these changes it may be appropriate for us to lead this work to help provide direction to these important aspects in a timely and coordinated manner.

Proposed scope: This will cover gas and electricity, and focus on potential uses of the enhanced meter data and its role in settlement. We will also consider changes to the customer switching processes. To the extent they are not addressed through the smart metering programme we will also look at whether the scope of the relevant codes and code administrators is appropriate in a smart metering world.

Scale and timescale: Subject to responses to this consultation, we would launch this as a SCR at the end of this year. We expect that a review period of at least 12 months would follow involving a series of workshops, meetings and consultations. We expect that we would produce initial findings and then follow this with more detailed final conclusions and potential direction(s) to the licensee(s) to make code changes.

SCR route: There are potentially significant benefits that can be achieved for consumers directly but also wider benefits to the environment. To secure these benefits it may be necessary to make changes to both gas and electricity codes including, but not limited to, the UNC and BSC.

Next Steps

We welcome your views on whether the three candidates selected as initial priority areas for a SCR fulfil the published criteria and are suitable to commence during 2010/2011. We request that **responses to this consultation** be sent to Abid Sheikh at abid.sheikh@ofgem.gov.uk to be received no later than **27 September 2010**.

Subject to responses to this consultation, we expect the next steps will be to individually confirm that we plan to initiate a SCR through a formal SCR launch statement. Throughout this process we will ensure that our thinking evolves with the direction of relevant Government policy. These statements will be published on the Ofgem website and formally issued to the relevant industry code panels. We anticipate that from 1 January 2011 onwards there will be provisions within the modification rules of the UNC, the BSC and the CUSC which allow proposals to be formally subsumed in the SCR process and not be allowed to progress unless considered urgent, or exempt. Until that time, and where relevant, we expect the code panels and parties to be mindful of this consultation.

Guidance on SCRs

As part of our Code Governance Review final proposals we indicated that we would publish further guidance on the launch and conduct of a SCR process. Today we have published this guidance on our website⁹.

Yours faithfully

Mark Cox

Associate Partner, Industry Code and Licensing

⁹ The guidance appears at: <http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Pages/Governance.aspx>

Annex 1

Electricity cash-out arrangements

Summary: The electricity transmission system must be kept in balance by matching supply and demand within prescribed technical limits. The System Operator (SO) for electricity, National Grid Electricity Transmission (NGET), is 'residual balancer' for the system, buying or selling electricity from or to generators and suppliers (or large customers) to balance the system. Actions taken by the SO for energy balancing purposes incur a cost. 'Cash-out' arrangements operate in the electricity market to target the cost of energy balancing incurred by the SO to those parties creating the costs, i.e. those parties not balancing their inputs and outputs within the relevant balancing period. Parties out of balance incur charges (cash-out) reflecting the costs incurred by the SO to address the imbalance. Cash-out is designed to provide market participants with strong commercial incentives to balance their contractual and physical positions and avoid exposure to cash-out, by contracting for supply ahead of time or by maintaining reliable generating plant.

<i>What outcomes are expected in terms of possible licence and code changes?</i>	<i>Would there be an impact across a number of industry codes and which codes are most likely to be affected?</i>	<i>Do these projects meet our criteria regarding suitability for a SCR?</i>	<i>SCR timing:</i>
Based on the issues raised by Project Discovery and through our review of P217A we currently expect code changes to the BSC only. These will focus on the cash-out arrangements.	No. We do not expect that changes would be required beyond the BSC.	Yes. There is significant impact from cash-out arrangements on maintaining the security of GB energy supplies and on the industry parties and competition.	SCR in 2010/11 We agreed to a review of P217A 12 months after its implementation so there is scope for action through a SCR. The issues identified in Project Discovery also point to the need for this to be considered at the earliest opportunity.

Gas security of supply

Summary: The UNC gas emergency arrangements (Section Q) set out how National Grid Gas NTS (NGG) declares an emergency and relinquishes responsibility for system balancing to a National Emergency Coordinator (NEC). There are five stages of alert. During Stage 1, NGG would indicate a potential gas emergency and maximise use of linepack, storage and interruption. Normal cash-out arrangements would apply. At Stage 2 (or beyond), the On-the-day Commodity Market (OCM) remains open but NGG can no longer be party to any trades and the NEC takes responsibility for physically balancing the system. Emergency cash-out prices are established, frozen at the prices prevailing at the point of entry into Stage 2 (or beyond) of the emergency. Parties offering gas onto the OCM in an emergency are paid for the additional gas and can claim the financial costs post-emergency. Modification UNC260, approved by the Authority in November 2009, established the principles of a post-emergency claims process.

<i>What outcomes are expected in terms of possible licence and code changes?</i>	<i>Would there be an impact across a number of industry codes and which codes are most likely to be affected?</i>	<i>Do these projects meet our criteria regarding suitability for a SCR?</i>	<i>SCR timing:</i>
<p>A review of gas security of supply is likely to lead to changes to the UNC, in particular those provisions relating to gas emergency cash-out and the compensation arrangements for firm customers disconnected. These potential changes to the UNC could also lead to licence changes, for example around the NEC's role. There may be wider aspects of the review that could lead to licence changes, for example around information provision.</p>	<p>No. The main impact would be on the UNC gas cash-out emergency arrangements.</p>	<p>Yes. Changes to the emergency cash-out arrangements are likely to lead to a significant impact on the security of GB energy supplies.</p>	<p>SCR in 2010/11 The UNC260 decision indicated that we would consider undertaking a wide-ranging review of the gas emergency arrangements.</p>

Smart metering impact on wider industry processes

Summary: The rollout of smart metering has an important role to play in the transition to a low carbon economy. There will be benefits for: (i) consumers, in terms of giving them information they need to fully understand and manage their energy consumption effectively and reduce carbon emissions; (ii) suppliers, allowing them to reform their processes – reducing costs and providing more streamlined customer service; and (iii) network operators, enabling more active management of energy networks (smart grids). DECC and Ofgem jointly published a Smart Metering Implementation Programme Prospectus on 27 July 2010, setting out proposals for how smart metering will be delivered, including the impact on the regulatory framework. One impact is the potential for significant changes to existing energy settlement processes resulting from the introduction of a smart metering.

<i>What outcomes are expected in terms of possible licence and code changes?</i>	<i>Would there be an impact across a number of industry codes and which codes are most likely to be affected?</i>	<i>Do these projects meet our criteria regarding suitability for a SCR?</i>	<i>SCR timing:</i>
<p>There are likely to be changes to the BSC and UNC where they interact with the smart metering regulatory regime. There may also need to be changes to other codes including the Master Registration Agreement (MRA) and Supply Point Administration Agreement (SPAA). The review may also identify changes to the licences of the network operators, as the current scope of the codes are in part set out in these documents.</p>	<p>Yes. Settlements processes in UNC and BSC and other codes:</p> <ul style="list-style-type: none"> ○ manage introduction of smart meters; ○ change settlement - profiling to more half-hour settlement; ○ settling energy for new and different tariff structures; and, ○ potential changes to scope of existing codes. 	<p>Yes. There will be a significant impact from smart metering on gas and electricity consumers and competition, across codes, and on achieving a low carbon economy.</p>	<p>SCR in 2010/11 While not an immediate issue today, a SCR process will allow the timely and coordinated consideration of code changes as the smart metering programme develops. Given the scale of potential changes it is important to start this work now.</p>