

Codes Governance

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| From | Ofgem |
| To | CMA |
| Date | January 2015 |

1. Introduction

1.1. In our decision to make a Market Investigation Reference (MIR), we identified a number of issues that we consider warrant further investigation by the Competition and Markets Authority (CMA), including the extent to which the complexity and scale of the regulatory architecture and the accessibility of the governance arrangements act as a barrier to effective competition, particularly for new entrants, new business models and smaller suppliers¹.

1.2. This paper provides some more background on the nature of the problem as we see it, the steps that we have already taken to address these issues, and our current thinking on what else might be done.

1.3. In broad terms we see two problems which we explore more fully below.

Barriers to Entry

1.4. Respondents to our state of the market assessment identified regulatory complexity and change as a burden and potential barrier to entry.² Smaller parties find it challenging to engage with the multiple industry codes and their change processes, and incumbents may have an interest in maintaining the status quo.

Delivering change to ensure effective competition

1.5. In addition to concerns the industry has raised, the regulatory architecture, in particular the industry code arrangements and governance processes, also give rise to wider issues around delivering timely change to ensure effective competition.

1.6. The industry led approach to code change works well to deliver incremental, non-contentious change to the operational procedures for which they were originally designed. However, it is not suited to delivering significant or cross-code/cross-sector reform.

2. The industry codes issues

Barriers to entry

2.1. Industry codes are detailed multilateral agreements including technical rules and obligations that govern participation in the energy sector, and are aimed at ensuring the end-to-end system works. There are a number of industry codes which (often necessarily/by their nature) are complex documents. There are also multiple bodies responsible for and/or administering different parts of the industry. Industry parties have to commit significant time and resource to understand and comply with the code rules in force, and further resource to engage in the change processes. While this could simply be seen as a cost of participation in the energy sector, smaller

¹ Paragraphs 2.39 and 3.20 of our decision of 26 June 2014.

² The burden that regulation creates was noted as something that impacts particularly on small suppliers. One respondent suggested that the Big 6 dominated industry processes.

parties in particular have told us they find this a burden and it could be seen as a potential barrier to entry.

- 2.2. Each code has its own Panel³ meeting, and each individual code change follows a set process, including in most cases having multiple industry working groups to develop and assess the proposed change. It requires a significant amount of resource to engage in all of these meetings and it may be more difficult for smaller market participants to identify where best to focus limited resource.

Delivering code change

- 2.3. As noted above, the code modification arrangements have worked well when handling incremental change. However, the industry-led approach is not suited to delivering significant or cross-code reform.
- 2.4. We have no general power to change the codes directly⁴. Changes are proposed by the industry and each of the codes has a process for the industry to develop and assess modifications (and to propose alternatives) through industry consultation and working groups, and for the relevant Panel to vote on the change. The Authority will then decide⁵ whether to approve or reject the change. We face significant difficulty in driving through change where there is industry opposition through a lack of incentives for industry to engage in the change process and cooperate with us in delivering timely and beneficial change in consumers' interests.
- 2.5. We are concerned that there is a lack of co-ordination between industry parties which can hinder the timely consideration of code modifications, the consideration of cross-code issues and delay the realisation of benefits for consumers⁶. Our concerns are heightened in the context of an evolving industry, in which the volume and pace of change is increasing as there is a need to deliver major reform in the coming years. For example to realise the full benefits of smart metering, including changes to allow more innovative services and much faster switching, will require significant cross-code modifications.

3. What we have done to address these issues

Barriers to Entry

- 3.1. In 2010 we completed our 'Code Governance Review' (CGR)⁷. Amongst other things, the CGR introduced licence obligations to mandate that Code Administrators (for the Uniform Network Code, Connection and Use of System Code and Balancing and Settlement Code) adhere to a new 'Code Administration Code of Practice' (CACoP)⁸ which we developed with industry. CACoP aims to facilitate convergence and transparency in code modification processes and to help protect the interests of

³ The industry code Panels are monthly meetings of (elected) industry representatives and other parties, including consumer bodies and Ofgem in an observer role. The Panels have a range of responsibilities, including responsibility for assessing proposals to modify the codes and, where changes have a material impact on competition and/or consumers, making a recommendation to the Authority on whether to approve or reject the change.

⁴ In limited circumstances (to facilitate compliance with the EU Third Package Regulations) we can raise a proposal to change a code. There are also examples where we have been given explicit powers in legislation to change codes for specific issues.

⁵ Some changes that do not have a material impact on consumers or competition can be decided on by the industry through the 'self-governance' processes we have introduced. The Authority is the decision maker for changes that have a material impact on competition or consumers.

⁶ We set out these concerns in an open letter to the industry in February 2014: <https://www.ofgem.gov.uk/ofgem-publications/85909/letteronindustryroleinsupportingdelivertoofsmartmeteringbenefits.pdf>

⁷ <https://www.ofgem.gov.uk/publications-and-updates/code-governance-review-final-proposals-4310>

⁸ <https://www.ofgem.gov.uk/licences-codes-and-standards/codes/industry-codes-work/code-administration-code-practice-cacop>

smaller market participants and consumers through the adoption of key code administration principles across all of the codes.

3.2. As part of this, Code Administrators (the bodies appointed by the industry to manage the code processes, including the change process) are required to act as a 'critical friend' in particular to smaller parties and new entrants. As a minimum, we envisaged this to include providing:

- assistance to smaller participants and consumer representatives (where applicable) with the drafting of modification proposals (particularly with regard to legal text); and
- a plain English explanation of the arrangements to which the relevant sections of a code relate.

3.3. In 2012, we consulted⁹ with industry on extending some of our CGR initiatives, including the CACoP and critical friend role, to the other industry codes. There were mixed responses from industry about whether to mandate CACoP for all the other codes, although there was broad agreement that CACoP had a positive impact in terms of promoting consistency and increased stakeholder engagement. We remained of the view that adherence to the principles set out in CACoP should make the governance of the codes more robust, facilitate a greater degree of participation, and generally lead to more effective decision-making. We therefore extended CACoP and the critical friend role to all the other codes under the second phase of our code governance review (CGR2)¹⁰, which was implemented in January 2014.

Delivering code change

3.4. CGR and CGR2 also introduced the 'Significant Code Review' (SCR) process. SCRs are aimed at enabling Ofgem to lead a holistic review of an issue that might result in significant cross-code and/or licence change. We took powers to direct licensees to raise proposals to implement our SCR conclusions. Experience has shown the SCR process can take a long time, and whilst we can direct the change to be raised following an SCR, it is ultimately for the industry to develop and deliver it under the 'standard' code change process. This means that the problems identified above can still arise (e.g. lack of industry coordination/industry processes not delivering change in a timely way).

Alternative business models

3.5. As well as looking at the code governance arrangements themselves, we have taken steps to enable new entrants to participate in the energy market. Related to this, we highlight two initiatives. The first is known as the 'white label' model where an organisation partners with a licensed supplier to sell energy using its own brand. We propose to accommodate this in our Retail Market Review reforms by allowing white label tariffs not to count towards the tariff cap (while retaining other requirements, such as those related to information)¹¹. The other is a model known as 'Licence Lite' which was primarily intended to support distributed generators who wanted to sell their own energy directly to consumers. Under Licence Lite the new entrant gets their own (electricity) supply licence but with provision for us to agree

⁹ <https://www.ofgem.gov.uk/ofgem-publications/61155/code-governance-review-phase-2.pdf>

¹⁰ See our CGR2 Final Proposals: <https://www.ofgem.gov.uk/ofgem-publications/61109/cgr-2-final-proposals.pdf>

¹¹ See our latest White Label consultation at: <https://www.ofgem.gov.uk/ofgem-publications/89723/whitelabelproviders-consultation.pdf>

(through a 'direction') that they can contract with another supplier to comply with some of the main industry code requirements¹².

- 3.6. These alternative models are helpful to new entrants who do not want to engage in the detail of energy market arrangements, but may bring a new dynamic to the market. They can also serve as a stepping stone to full market entry.

4. What else could be done

- 4.1. We have asked industry to identify options for better coordination under the current, industry led framework¹³. There may be scope for the System Operators and/or industry Panels to adopt a more strategic role in managing what change is brought forward. We note that, as a result of industry responses to their annual CACoP review, the Code Administrators are developing a proposed change to introduce an explicit requirement for Code Administrators to ensure there is more effective cross code coordination.
- 4.2. These steps alone may not be effective in addressing the barrier to entry concerns and ensuring we and the industry can deliver the significant volume of change needed in the coming years (for example to deliver faster switching and other smarter markets reforms). We think it is right to explore the case for additional powers to enable us to ensure code change is delivered.

Scale of codes/code consolidation

- 4.3. It has been suggested that Ofgem should review the scale of the codes and the possibility of reducing/consolidating codes. This is something we considered in 2011/12, when establishing the scope of our Smarter Markets Work Programme. We consulted on the following proposition¹⁴:

"The Smart Energy Code should be used as a vehicle to consolidate existing industry codes dealing with retail issues in gas and electricity to facilitate market development and reduce administrative burdens".

- 4.4. Many respondents agreed with the proposition, arguing that this could reduce administrative costs, lower barriers to entry and helpfully align gas and electricity arrangements. There was support for Ofgem to drive consolidation but there were mixed views on when any changes should be implemented.

¹² To note, we have not received any formal requests for Licence Lite derogation to date, although we are engaging with a number of parties on this. Also to note, we have recently consulted on revised Licence Lite guidance: <https://www.ofgem.gov.uk/publications-and-updates/licence-lite-proposed-revisions-slc-11.3-operating-guidance>.

¹³ For example, see our open letter at the link in footnote 5.

¹⁴ Our December 2011 consultation document is available here: <https://www.ofgem.gov.uk/ofgem-publications/42597/smarter-markets-strategy-consultation-document.pdf>