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By email

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Dear Maxine,

Further review of industry code governance

We welcome Ofgem's engagement with the industry on the issue of industry code governance and we agree with Ofgem on the need for further reform.

You will recall that we provided a paper to Ofgem in March 2015 setting out our views on this subject (attached for reference). This paper considered many of the points raised in your letter and specifically Questions 2 and 3. Our response to Question 1 is attached to this letter.

In summary, Centrica believes that the current industry codes framework adequately supports incremental improvement but agrees that it is not well-suited to delivering strategic or transformational change. A current example is the delivery of strategic gas settlement reform under Project Nexus.

There are a number of critical elements to the delivery of change on the scale envisaged by the Smarter Markets team. The overhaul of code governance arrangements should be included within the delivery programme for transformational change and should take greater account of the dual fuel retail market for energy. Failure to do so risks ultimately adding time, costs and coordination overheads, and could leave an incoherent collection of legacy codes, many of which may have lost their original purpose.

In respect of changes introduced under CGR and CGR2. We believe that the quality and consistency of Impact Assessments could be improved and there should, where required, be a form of post implementation review to ensure that costs and benefits are correctly predicted.

SCR timescales have significantly exceeded expectations, a reflection of the complexity and impact of these changes to market participants. Ofgem is in control of key sections of the overall process and has a major part to play in ensuring that it remains focused and on track. If areas of complexity

remain in the modification process, sufficient time should be allowed in order for the modification group to develop solutions to enable implementation.

Industry codes and code administration reflect the complexity of the underlying regulations. They therefore require commitment and expertise from all involved industry players; if the regulation could be simplified it may be easier for smaller players to become more involved, but some areas are inherently complex and here other approaches (various forms of shared representation and/or third party advice and support) could help to ease resourcing challenges.

The breadth of governance reform required to deliver the scale and scope of transformational change expected in the coming years should not be under-estimated. The case for clear direction and leadership in this area is self-evident as none of the Codes has the *vires* to deliver change that is broader than their own scope. Subject to the CMA's on-going investigation and the publication of their provisional findings, we suggest that a clear strategic vision is required, controlled and directed by a design authority, detailing how market and governance arrangements will need to evolve to align with policy goals and improve the overall effectiveness of industry codes.

Further, it would be helpful for Ofgem to establish specialist Programme Management and Chief Economists Units within its organisation.

A dedicated PMO would help Ofgem and the industry to manage future SCRs and other complex industry change processes we are likely to experience in the forthcoming years, looking at the end-to-end change programme and bringing in specialist external support as/when required. A small Chief Economist team could focus on the way economic, market and financial analysis is applied across the range of major industry change, including SCRs, to ensure a consistent, high quality and co-ordinated approach to impact assessments – including the way in which external analysis is commissioned and integrated into Ofgem's final impact assessments.

We would welcome the opportunity to discuss with Ofgem how these thoughts could be developed further.

Yours sincerely,

Andrew Pearson
Head of Smart Metering and Industry Codes

Question 1: Do you consider the changes introduced under CGR and CGR2 have been effective in improving the code governance arrangements. In particular considering the efficiency of code change, the ability for large scale reform to be implemented, and the accessibility of the arrangements for smaller/newer industry participants and consumer representatives?

The governance reforms introduced under CGR and CGR2 included the four elements, as detailed within Annex 1 of the open letter. We have provided below some views on each of these areas.

Significant Code Review (SCRs)

- Much of Centrica's experience of the SCR process to date has been in the wholesale energy space. Ofgem raises three specific examples – Gas Supply Security, Electricity Transmission Charging (TransmiT) and Electricity Balancing – all of which we have had engagement with.
- Although we did not support a number of Ofgem's final SCR decisions, we acknowledge that this letter concerns process rather than content. It is apparent (e.g. as regards aspects of Electricity Balancing) that the SCR process, and additional powers granted to Ofgem under the Gas Act 1986 (as amended) to directly amend the UNC outside of normal code change processes, already allow Ofgem to push through change which commands little industry support. This was, as we understand it, the intention. On that basis there seems to be no need to grant Ofgem additional statutory powers in this respect.
- The quality of Impact Assessment during the Ofgem-led phases has been inconsistent. It is important to ensure that IA plays encourages stakeholder contributions and feedback at an appropriate early stage, rather than simply justifying a decision which has (in effect) already been taken. In some cases, such as the Gas Supply Security SCR, the analysis was led from Ofgem and the level of stakeholder engagement (before the initial IA was published) was, in our view, inadequate. In other cases, such as TransmiT, there was great reliance on industry analysis, but the quantitative analysis used did not support the conclusions that Ofgem drew. There would be benefit in considering how this situation can be improved. One possibility would be to establish a focused economic analysis unit within Ofgem. For highly specialised areas, such as electricity balancing, there would be benefit in ensuring that expert analytical capability is engaged throughout the process.
- To date SCR timescales have reflected the sheer complexity of the issues involved and their far reaching impact on market participants. However, we believe that clearly defined objectives at the start of the process and intervention by Ofgem to ensure the process remains on track could help to ensure that SCRs are conducted more efficiently and in line with the expectations of both Ofgem and the industry. We agree with Elexon (in its response to the CMA's UIS) that it is worth exploring the scope to eliminate duplication and overlap between the Ofgem-led and industry phases of an SCR (especially in relation to impact assessments).
- We also consider that SCRs would benefit from Ofgem introducing a project management unit that would take a more active role at key stages, e.g. in setting clear

SCR goals, deliverables and realistic project milestones, as well as remaining more actively engaged in industry discussions to help 'steer' the process. For example, within the SCR on Electricity Balancing, the modification process felt quite rushed in places and there was insufficient time allowed to develop ideal solutions (i.e. the RSP function). If the modification process is tasked with developing a practical solution to enable the implementation of a change, it is important for this to be given sufficient time.

- SCRs can be complex projects/programmes to manage end-to-end, recognising the industry implementation process which typically needs to follow a final Ofgem decision. As with previous wide-reaching industry change programmes, such as retail market opening or the transition from the Pool to NETA, we believe that the engagement of a specialist programme manager should be considered or, as previously suggested, setting up a Project Management Unit. The purpose would be to help Ofgem steer the entire SCR process from conception to implementation of change.

Code Administration

- Code administration reforms have in general been welcome where they have sought to bring a degree of consistency across the numerous industry codes.
- We note, however, that following Ofgem's initial code governance review, code panel meetings (especially UNC) are now typically much longer. We believe this primarily a consequence of the requirement to take and record decisions formally. While this undoubtedly makes the development of code modifications more process-driven and transparent, the perceived resourcing burden may not help as regards the engagement of smaller shippers/suppliers.
- Industry codes and code administration generally reflect the complexity of the underlying regulations. They require commitment and expertise from all involved industry players. If the regulation could be simplified (e.g. more principle-based) it may be easier for smaller players to become more involved. Additionally, the timing and volume of change going through process has an impact on the market participants that play a role. In respect of the UNC, we note that the Joint Office can act as a "critical friend" to shippers, that there is the availability of pre-Panel briefings run by the Joint Office and that there is the participation, at key industry meetings, of certain companies who do or can act on behalf of smaller shippers/suppliers. Smaller suppliers may also benefit from the support of Energy UK and dedicated 'smaller supplier' sections within industry associations, such as the Gas Forum.
- As per our response to the CMA, we can see potential benefit in harmonising / streamlining code administration, in terms of processes and administrators. The move to dual fuel obligations and governance arrangements, for example next day switching and centralised registration, will require significant change to the incumbent governance arrangements, which we believe would be best addressed by strategic reform of the current arrangements, rather than via piecemeal, consequential changes to the existing landscape. This reform should include the code administration of any revised industry governance landscape and the establishment of fit for purpose change processes that deliver the requirements of the revised arrangements.
- There may also be scope to rationalise industry credit and collateral arrangements providing there is no risk sharing between market participants. At the same time, there can be legitimate reasons for some codes (such as BSC) to require collateral in cash or

as LCs, whilst collateral permitted in respect of T&D access charging (which is not so real-time critical) may include PCGs. We would not support a general relaxation of industry credit requirements given the magnitude of potential residual exposures.

Self-governance

- We do not consider that there are any fundamental flaws with the principle of industry self-governance and (as mentioned above) we note that this principle is already qualified in certain areas by the scope to initiate an SCR, where appropriate.
- In particular, we do not consider that an appropriate review and reform of industry code governance would require any additional legal powers to be granted to Ofgem.

Charging methodology

- Our views on major changes involving charging methodologies (such as Transmit) which fall under the SCR process are set out above, however we agree that it would be useful to consider whether there are ways to make the governance of charging methodologies more effective and efficient.
- As there are clearly-defined dates when changes to charging methodologies become effective in terms of affecting customers (i.e. when price changes, generally on the 1st April), this makes setting a timetable for managing change proposals a viable option. It is likely that a clear timetable would enable the industry to manage changes more efficiently.
- If a party wishes a change proposal to affect charges from the April of a given year a series of deadlines could be set out. Potentially, these could include:
 - Raising of issues/draft proposals to industry expert review group
 - Raising of change proposals
 - Report sent to Ofgem for decision
 - Ofgem decision
- Many of the codes already have what are in effect industry expert review groups. There is potential for the role of these groups to be formalised. For example, it could be mandated that change proposals are presented to this group before being raised. The group could provide advice and analysis to inform the change proposals, although the final decision on whether to raise the change would still remain with the proposer. This group could also take responsibility for managing change proposals. This would ensure analysis completed at the draft stage is not unnecessarily repeated and would allow proposals to be assessed by the same working group when appropriate.
- Such an approach would allow related changes to a methodology to be considered 'as a package' rather than on a piecemeal basis. An example of where this approach would be helpful is the current Ofgem-initiated review of gas transmission charging triggered by the proposed European TAR-NC. Although closely related to the question of commodity charges for transmission, the issue of 'shorthaul' tariffs has been relegated to an apparently separate process led by National Grid.
- Ofgem has chosen not to launch an SCR in respect of gas transmission charging methodology, but this is in our view a suite of major changes which raises many of the same process management and process quality issues as an SCR and so is not well served by the current code governance arrangements.

- Both implementing a timetable and packaging proposals together would change the nature of the workload for the industry. It is likely to bring more concentrated periods of activity but on a more predictable basis. An assessment would be required as to whether this is preferable overall.
- There would be merit in bringing other key gas methodologies within the UNC governance framework, particularly those concerned with the release and substitution of NTS entry and exit capacity.