

Reforming the Energy Industry Codes

Submission to BEIS/Ofgem Consultation

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About the author

This submission has been prepared by Matthew Lockwood (Senior Lecturer in Energy Policy) from the Sussex Energy Group (SEG)¹ at the University of Sussex. (<http://www.sussex.ac.uk/profiles/1625>).

The group aims to understand and foster transitions towards sustainable, low carbon energy systems. We undertake academically rigorous, interdisciplinary and world-leading research that is relevant to contemporary policy challenges.

Executive Summary

The broad thrust of the codes governance reform proposals is to be welcomed. There is ample evidence that the current codes system is fragmented, highly complex and largely disconnected from high-level energy policy goals, especially decarbonisation. The current system of self-governed regulation in practice favours large established incumbent actors, creating barriers to entry and innovation.

We therefore agree with the proposal to move away from industry-led codes governance, to governance arrangements located in the public domain. We believe that locating this function in Ofgem it is not an effective solution. There are arguments for locating it in the ESO, or a reformed SO body that encompassed electricity and gas, but only if the SO were completely independent of National Grid Group. Otherwise an independent body is preferable.

We also agree with the principle that codes governance and codes modification be clearly and transparently linked to higher level policy objectives, and especially to the achievement of net zero GHG emissions by 2050 (with associated carbon budgets). However, a 'strategic function' seeking to make these links will be able to do so effectively only if there is clear strategic direction for energy system change at a higher level, which in many areas is not currently the case. We therefore welcome the statement that a review of the wider governance of the energy system is forthcoming next year.

Introduction

The Sussex Energy Group (SEG) welcomes the opportunity to respond to the consultation on energy industry codes governance. The broad thrust of the proposed reforms are highly welcome.

This submission focuses in particular on the nature of the problem with the current framework, on the broad vision for reform, and on the proposed 'strategic function'.

The submission is organised using a selection of the consultation questions.

Answers to Selected Consultation Questions

Background and scope

1. Do you agree with our four desired outcomes for the code governance landscape by the mid-2020s? Yes/No/Don't know. Please explain. If you disagree, please explain what you consider the outcomes should be.

1.1 These are desirable outcomes. However, the priorities should be made clearer and potential conflicts and trade-offs acknowledged.

1.2 Part of the wider problem of energy governance in the UK is the absence of clarity about priorities in the setting of remits for delegated governance functions (e.g. to Ofgem,² to codes governance etc.³). Because there are potential conflicts and trade-offs between the four outcomes listed, the Government should give a clearer statement of priority amongst them.

1.3 In our view, the overwhelming priority for the codes system should be to support the transformation of the energy system needed to meet the recently adopted UK target of net zero carbon emissions by 2050. It should do so in such a way that no unnecessary costs are borne by consumers. This implies that outcome 2 should be given a higher priority than the other outcomes.

1.4 The main potential conflict or trade-off here is that reaching outcome 2 may involve a degree of direction and stability (under either Model 1 or Model 2) that will need to be combined with a system that is simultaneously agile (outcome 3) and able to accommodate a large and growing number of participants (outcome 4). This will especially be the case if the current approach of all participants being able to propose modifications is retained.

2. Do you agree with the problems we have identified (in chapter 1 – Background – and in later chapters), and that they present a persuasive case for reform of the current framework for energy codes?

Yes/No/Don't know. Please explain.

2.1 Yes. In extensive published research on the GB codes governance arrangements with colleagues at the University of Exeter⁴ we identified major problems with:

- Complexity and fragmentation, both of which act as barriers to smaller new entrants (because they increase fixed costs)⁵ and also make systematic and

non-incremental changes slow and difficult. An example of this last point is the approach to embedded benefits.⁶

- Dominance of codes governance by large incumbent actors; in 2015 distribution network companies and large suppliers vertically integrated in electricity made up a clear majority of representatives on codes bodies, with the exception of the BSC and the SEC.⁷ The extent of industry dominance in the codes governance system is such that we consider the current approach to be a form of 'self-authored regulation', because it combines significant influence of industry over the content of codes together with the authority of regulation (as opposed to voluntary codes of practice)
- A gap between high-level policy objectives and the formal objectives of codes; for example, with the exception of the SEC, these objectives do not make reference to environmental sustainability, let alone carbon budgets.

3. Do you have additional evidence on the performance of the current framework?

3.1 See 2.1.

4. Do you agree with our proposed scope reform? Yes/No/Don't know. Please explain. If not, which additional codes or systems do you think should be included/excluded?

4.1 Yes. However, the broad thrust of the reform of codes should also apply to reviews of related engineering regulations for electricity, i.e. the Engineering Regulations P2 for distribution networks and the Security and Quality of Supply Standard for transmission. Similar issues apply to the governance of these regulations, including dominance by incumbents and insufficient oversight by Ofgem and the Government. We suggest that a parallel review of governance arrangements (as opposed to the regulations themselves) for these regulations be carried out.

5. Are there any codes or systems that we should only apply a limited set of reforms to? Yes/No/Don't know. Please explain.

5.1 No. Because many industry participants are required to be parties to multiple codes, and because one code will often refer to another, they effectively form a network which should be approached as a whole.

Vision & options

6. Do you agree that the four areas for reform are required? Please provide reasons for your position and evidence where possible.

6.1 Yes. However, for '1. Providing strategic direction', a reformed codes governance system can only achieve such an outcome if clearer strategic direction is given at a higher level of decision-making. The current framework, as contained in the Clean Growth Strategy (CGS), does not give sufficient direction. For example, the CGS does not contain a clear strategy for the growth of electric vehicles, with targets, a timetable and a coordinated set of policies on market support and infrastructure, which is consistent with the indicative requirements

published by the Committee on Climate Change.⁸ Codes can support strategic direction if (and only if) that direction is clearly indicated.

Another example would be the future of the supplier hub; it is clear that this principle is under question and it is likely to be abandoned, but the relevant amendment of codes (which would have to be substantial) will depend on the specific model that replaces the supplier hub. At the same time, concerns about regulatory risk (already expressed in previous codes governance reviews)⁹ can credibly be met only through clear and transparent links between higher-level strategy and policies for energy transformation on the one hand, and particular code changes on the other.¹⁰ This is why we believe that a pre-requisite for codes governance reform is a consideration of the wider energy governance system, as discussed in 1.2 above and 10.2 below. We note that a wider review of GB energy governance is indicated in the next steps of the consultation document, which we strongly welcome.

6.2 In relation to '2. Empowered and accountable code management', we would argue that this area should be defined as 'Empowered, integrated and accountable code management', since greater integration of governance across codes (even if simplified) is needed to overcome problems of fragmentation.

6.3 We agree with the need for reform in the area of '3. Independent decision-making'. We note that previous rounds of reform, such as the 2008 review that introduced Significant Code Reviews, and the more recent reforms following the Competition and Markets Authority Energy Review in 2016, have moved incrementally towards more independent decision making, while remaining within the model of 'self-authored regulation' (see response to Q.2 above). In our view, a more strategic step towards independence is needed, because there is little incentive for the needed reforms from within the current governance arrangements.

6.4 In relation to '4. Code simplification and consolidation' we agree with the need for this element of reform. The background research conducted by the Brattle Group/ Simmons and Simmons¹¹ for Ofgem's 2008 codes governance review demonstrated the feasibility of simplified and consolidated codes. One common counter-argument to simplification of codes is that the energy system is inherently complex. Whilst it is arguable how much of that complexity is actually required, it should be noted that in other jurisdictions with relatively simple codes, such as in Scandinavian countries, some of the complexity is then located in specific bilateral contracts. In our view, such an approach is preferable, but it does then require sufficient protection for smaller energy market participants, including, for example households as prosumers or as providers of demand flexibility. A minimal degree of protection should be located somewhere in the system, either within codes or within contract law.

7. Do you agree with the two broad models outlined? Please provide reasons for your position and evidence where possible.

7.1 As discussed above in 1.1 and 6.1 and 10.2 below, the main weakness in both models is the link between the Government's vision and the strategic body/function. If the vision is not sufficiently specified by Government, it will effectively be delegated to the strategic body/function to interpret this vision, which in a broader form has been a major problem in GB energy governance to date. That is why we consider that there should be: (i) a clearer link in both models to

the carbon budgets; and (ii) an energy transformation body that transforms the carbon budgets into a strategic direction for policy more effectively than is currently the case.

8. Which model do you believe will best deliver on our desired outcomes? Please explain. NB: – further detail can be found on each model in the chapters that follow.

8.1 In principle, we believe that either model could work. However, factors such as the direction given by the Government's vision, and the necessary resources, knowledge and expertise that a new body will need to function effectively, are more important than whether code management functions are integrated or not. That said, we favour Model 2, as we believe that it is more likely, as an integrated body, to deliver the clear and transparent linkages between particular codes changes and policy objectives that will be needed to counter perceptions of regulatory risk.

9. Do you agree with the changes to the role of code signatories we are proposing?

9.1 Yes. As noted in 6.3, we believe that previous incremental reforms that maintained the same fundamental role for code signatories in governance have not been effective.

Providing strategic direction

10. Do you agree there is a missing strategic function for codes development in the energy sector and introducing a strategic function with the responsibilities outlined in chapter 3 is the best way to address the lack of strategic direction? Yes/No/Don't know. Please explain.

10.1 We disagree with the statement that, 'There is no single organisation responsible for ensuring the codes are updated to take account of government policy or wider changes, or that the various codes and related IT systems evolve in a consistent and joined up manner, that is in the interests of existing and future customers.' In fact, Ofgem has overall responsibility for this role, but has historically struggled to carry it out effectively because: (i) of the place it is allotted within the codes governance arrangements; (ii) a lack of sufficient knowledge and expertise to overcome problems of information asymmetry; and (iii) a poorly defined remit, which combined with a lack of strategic direction set by Government and fear of legal challenge from market participants, means that it struggles to play a strategic function with respect to codes change. In a submission to the 2015 CMA Energy Review Ofgem itself suggested to the CMA that 'as an economic regulator it is not efficient or effective for it to lead on the delivery and/or take a prominent role in drafting and implementing detailed and often technical code change in an ongoing basis.'

10.2 We agree with the view that there is a missing strategic function in the energy sector, but that this problem is at a higher level than that of codes development (see above), and that unless this underlying problem is addressed, a new 'strategic function' for codes will struggle to be effective. A recent example is Ofgem's Targeted Charging Review, which is attempting to balance the objective of fairness with that of encouraging the growth of low carbon generation. It is

reasonable to expect that there will be mixed policy objectives involving conflicts and trade-offs, but it is not appropriate that fundamental political decisions about trade-offs should be made at the codes governance, or even at the regulator level.

Who is best placed to fulfil the strategic function and why?

10.3 Not Ofgem; see 10.1. A strategic function could sit in a codes governance body within the electricity SO, but if it were to have legitimacy this would only work if the SO were completely independent of National Grid, which it is currently not. The advantage of such an arrangement is that the codes body would have access to good information and expertise on the electricity system, which is the most relevant for transformation of energy. Alternatively a fully independent body would be preferable.

11. Do you agree with the objectives and responsibilities envisaged for the strategic function, and are there any additional objectives or responsibilities the strategic function should have?

11.1 The issues raised in 1.2, 6.1, 7.1 and 10.2 raise the question of how greater clarity on strategic direction for the UK energy system can be given at a higher level, and whether a strategic function for identifying code changes could also provide this higher level direction. On the argument that Governments will fail to provide appropriate long term direction for energy system transformation because they will be swayed by short term political concerns, some argue for delegation of decision making (or at least advice) to a some form of energy agency, or energy transition body, along the lines of the Committee on Climate Change or the National Infrastructure Commission. It may be the case that such an institution is needed, although it will not be sufficient, since major transformation of the energy system will require support from the public which such agencies cannot easily build or mobilise.¹² But in any event, the function of setting strategic direction more widely, and that of setting a strategic direction for code change specifically, should not be rolled into one body, since these two functions operate at very different levels of governance.

Empowered and accountable code management & independent decision making

15. Do you agree that in addition to the current responsibilities that code administrators have, that a. the code manager function should also have the following responsibilities: a. identifying, proposing and developing changes (analysis, legal drafting etc.), including understanding the impacts; b. making decisions on some changes, or making recommendations to the strategic body; and c. prioritising which changes are progressed. Yes/No/Don't know. Please explain.

15.1 Yes. These functions are essentially what codes bodies (i.e. panels etc.) currently do, and it is appropriate that they be moved to a new body. However, to carry out these functions effectively (and without constant legal challenge or appeal from industry actors), the most important issue is that the code manager function should be properly resourced, with people who have (or can develop) the necessary knowledge and expertise. To understand impacts, the code manager function may also require the authority to demand information and data from industry participants, and thought should be given to the terms on which this authority operates.

24. What would be the most effective way to ensure the code manager function offers value for money (for example, through price controls or budget scrutiny)? More broadly, what is the right incentive framework to place on the code manager function?

24.1 A price control is not an appropriate instrument for a non-asset based activity, as the experience with setting a price control for the ESO has shown. Tendering is also problematic, as specifying and estimating the needs of codes change over a significant period (e.g. 5 years) would be virtually impossible, and require second guessing the strategic function. Complex incentive structures are overkill in this context – making the code manager a NDPB with ordinary budgetary oversight and strong steer from the strategic function is a more sensible approach.

Further Information

For further detail on any aspect of this submission, please contact Matthew Lockwood (Senior Lecturer in Energy Policy) on 01273 873539 or m.lockwood@sussex.ac.uk.

¹ See <http://www.sussex.ac.uk/spru/research/themes/sussexenergygroup>

² <https://projects.exeter.ac.uk/igov/new-thinking-the-odd-couple-will-a-new-strategy-and-policy-statement-help-sort-out-the-relationship-between-government-and-ofgem/>

³ Lockwood, M. et al (2015) *Innovation and energy industry codes in Great Britain*. Working Paper 1508, Energy Policy Group, University of Exeter, <https://projects.exeter.ac.uk/igov/working-paper-innovation-and-energy-industry-codes-in-great-britain/>

⁴ Lockwood et al (2015); Lockwood et al (2017) The governance of industry rules and energy system innovation: The case of codes in Great Britain. *Utilities Policy*, 47, 41-49, <https://www.sciencedirect.com/science/article/pii/S0957178716301266?via%3Dihub>

⁵ For example in the proliferation of different collateral and credit requirements across codes – see Cornwall Energy, (2014) *Credit and Collateral in the GB Energy Markets*, vol. I. Main Report,

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348145/Phase_1_volume_1_credit_and_collateral_in_the_GB_energy_markets.pdf

⁶ <https://projects.exeter.ac.uk/igov/new-thinking-the-embedded-generator-saga-and-codes-governance/>

⁷ Lockwood et al (2017), Table 4.

⁸ CCC (2018) *Reducing UK emissions: 2018 Progress report to Parliament*

⁹ E.g. E.On, U.K., 2008. Code governance review: major policy reviews and self governance. <https://www.ofgem.gov.uk/sites/default/files/docs/2009/07/e.onresponsee-84-09.pdf>

¹⁰ See Lockwood et al (2017, p. 47)

¹¹ Brattle Group/Simmons and Simmons (2008) Critique of the industry codes governance arrangements – A report for Ofgem, <https://www.ofgem.gov.uk/ofgem-publications/61470/20080612-codesgovernance-review-final-draft.pdf>

¹² <https://projects.exeter.ac.uk/igov/new-thinking-building-political-consensus-for-energy-transformation-in-britain/>