

To: CodeGovRemedies@ofgem.gov.uk

30 January 2017

Re: Response to Ofgem's consultation on Code Governance implementing the CMA recommendations

Until recently, I was a Senior Partner at Ofgem and, among other things initiated and led the early work on code governance reform. I am now working as an independent consultant (Grid Edge Policy) and looking to continue to contribute to thinking on how the energy sector needs to transform, in particular bringing a consumer perspective to the debate. This response is submitted in a personal capacity.

Having initiated the thinking within Ofgem on the need for fundamental reform of the code governance arrangements, including getting the issue on the CMA radar, I am very pleased to see this work now being taken forward. This is a critical initiative which is fundamental to delivering the smarter energy system that is core to Ofgem and government's vision for the sector.

However, from my past deliberations in this area there are a number of points that I am keen to ensure are not lost and which I have set out below. I have not tried to link them to specific consultation questions but hope they are helpful nonetheless.

1) The need for a broader view on the rationale for reform

The consultation focuses understandably on the CMA analysis and the implementation of the CMA remedies. However, Ofgem's responsibilities and perspective is wider than the pure competition focus of the CMA – and certainly wider than the focus on retail market competition which was the basis of the reference.

The consultation rightly looks across the full panoply of codes in terms of the question on what the scope of the reforms should be, but then fails to put the debate in the context of wider energy system changes that have implications for the institutional arrangements that may be needed going forward.

In particular, looking at the implications of decarbonisation and the shift to greater distributed energy and demand side participation, the EIT/Systems Catapult work on the Future Power System Architect project is looking at the functions that will be required for a 2030 energy system. While Ofgem's work is in many ways pointing in the same direction in terms of the need for greater co-ordination across parties (and codes) it is important that in thinking about roles and where there may be synergies between codes, Ofgem draws on the expert work approaching the question from a technical engineering perspective. There is a nod in this direction with the reference to greater convergence between Grid Code and Distribution Code but a more systematic assessment of these changes is needed.

Similarly, while there are a few references to the work looking at the future role of the SO, the consultation underplays the extent to which the drivers for the SO review are closely linked with questions around code governance. With the decision now published on the future role of the SO and plans for separation, it is important that consideration of options for the SO role takes account of the extent to which this might create opportunities for NG to take on a proactive code manager role across a wider set of codes which would not be possible unless the SO were clearly more independent. For example, if grid code and distribution code were brought together NG could

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manage a combined code but it would probably not be acceptable to distribution networks for it to take this on where there could be conflicts with NG's TO role.

2) Business Models Matter – but the answer isn't easy

One of the questions that gets raised in many of the discussions around industry governance is what sort of body should take on the role of code manager. In some cases internationally this role is taken on by a public sector body which can be relied on to act in the public interest. Ofgem and the CMA have quite reasonably chosen not to go down this path but instead to use the mechanism of a licence and accountability to drive the right behaviours. However this is not straightforward and given the opportunity of a blank sheet of paper more thought should perhaps be given as to whether different structures / business models would make the regulatory task easier. While “structural remedies” may be generally viewed as disproportionate, if you are anyway going down that path then getting the structure right from the start seems to make sense.

The consultation says that it doesn't intend to prescribe business models in order not to limit competition. However the choice between a “not for profit and “for profit” body is fairly fundamental and further exploration of the extent to which this would impact the ease of regulating the body – and hence whether Ofgem should be more prescriptive – would seem justified. For example:

- A not for profit body could be culturally aligned with the objectives that it is required to deliver without a competing profit motive – or may at least be seen that way by others where confidence in the system is important;
- However the ability to drive certain behaviours through financial incentives will not work in a not for profit context.

The answer is not obvious and the fact that allowing “for profit” models is likely to open up a pool of wider applicants may indeed be the decisive factor but it is not the only consideration.

Similarly, the questions around whether delivery bodies need to be separately licensed or can be combined with the code manager role (the approach Ofgem proposes) may depend in part on the business models adopted. In my view Ofgem underplays the problems around potential conflicts – but also the potential synergies. The biggest risk in terms of conflicts of interest – in particular in a “for profit” model – is not that the code manager goes for the easy option but that it over-engineers the solution or supports new functionality in order to provide extra work for its own delivery body. It is writing the spec for work it will deliver. The consultation suggests that this conflict can be managed through “incentives” but it is extremely hard to see how that would work in practice and the normal regulatory approach in such situations would be to require at least a level of separation.

The counter argument is that there are real synergies from having the code manager and delivery body together. These are not simply about getting good cost estimates to feed into a CBA but about a real in depth understanding of the systems and processes which are involved, both to run the systems but also to consider how changes might best be delivered. This is the Elexon model. It is also worth remembering that the delivery bodies can have two quite distinct sets of responsibilities – for developing the systems or building new systems but then also an operational role in running these systems. The conflicts and synergies may be different for each of these and need to be thought through.

While it may be the right answer to have a single licence, Ofgem seems to have reached that conclusion prematurely. A decision on the right approach can really only be taken once the

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landscape of code managers (ie which codes might be jointly tendered) has been fully thought through. There are then a range of other factors that Ofgem would need to build into any decision. A single licence is likely to be more administratively efficient. However the appropriate length of time between retendering is almost certainly different for a code manager (an administrative function) versus a delivery body with physical systems and assets (where a decision also needs to be taken on whether existing assets are transferred across or systems rebuilt from scratch by a new body).

The right answer for how delivery bodies are managed will inevitably depend on the precise tasks involved. Ofgem should not rule out the idea of separately licensing delivery bodies until it has completed this next level of analysis.

3) Learn lessons from SEC / DCC

While the majority of industry codes and systems have been in place since industry opening and were clearly designed for a different world, the arrangements to support smart metering were put in place relatively recently and all of these debates and arguments – around the role of competition, how to incentivise thinly capitalised bodies, separation or not between code management and delivery – were all thoroughly debated. It is therefore worth going back and understanding the reasons that particular approaches were taken for SEC / DCC – and also looking at what has happened in practice, to learn any lessons. Clearly the smart metering programme is on a much larger scale than any of the programmes being envisaged here which may be a reason for different approaches being taken. As the consultation alludes, thought also needs to be given as to whether changes are needed to the SEC / DCC arrangements if they end up out of step with what is being done elsewhere – and understanding the history will be key to deciding on this.

Some of the immediate points that come to mind in relation to SEC / DCC:

- The approach taken here was to licence the delivery body but not the code body, although the code body was appointed through competitive tender (carried out by DECC, now BEIS, on behalf of the SEC panel who hadn't been appointed at that stage but who ultimately signed the contract). A tender was also carried out for the DCC licence.
- The reason for wanting to licence DCC was that delivery was seen as critical and hence the ability for Ofgem to have direct oversight of the delivery body was key. Incentives could then be included in the DCC licence for timely delivery of the systems – with consultation now ongoing as to how those incentives need to change for the operational role it is now taking on. While DCC might be badged as a “delivery” body it is in fact carrying out more of a programme / contract management role with the systems delivered through the various fundamental service providers (covering comms, data handling, SI etc). The incentives on DCC ideally have to then be mirrored in the contracts it has with these service providers, which could provide a model for how a code manager could work with a delivery body in other codes.
- There are difficulties in how best to incentivise DCC. Even with the scale of operation that they are overseeing their profit margin which can be put at risk in terms of incentives is limited in absolute terms and the asset light nature of their business limits how much revenue can be put at risk without threatening the financial viability of the company. Again there may be lessons for the approach to incentives for other code / delivery bodies.
- Where services are tendered for with cost as a key element of the tender, you then have the challenge of how to deal with any variations to the costs as the scope of work changes. The Ofgem consultation doesn't talk about how the bodies would be funded or how budgets would be set. In DCC's case it has been subject to an ex post price control, although there is

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discussion about moving to ex ante. Ex post price controls are difficult creating only downside risk for the company and weaker efficiency incentives – but where the scope of the work is uncertain ex ante regimes are harder to apply.

- In contemplating the role of DCC the need to have separation from SEC was driven in large part by the need to avoid conflicts of interest. DCC is a party to the SEC but the job of the SEC panel is effectively to oversee the relationship between DCC and its users (in the interests of consumers). If DCC were also SECAS then it would always be looking to serve its own interest.
- In running the tender for SECAS, DECC will have got a sense of the level of interest from external parties in this sort of code manager role which may be helpful in considering the potential for tendering code administrator roles more generally.

I hope these comments are helpful.

Yours sincerely

Maxine Frerk

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