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5<sup>th</sup> August 2015

Dear Will,

## **ENERGY MARKET INVESTIGATION – PROVISIONAL FINDINGS**

Thank you for the opportunity to respond to your Notice of Provisional Findings ('Notice'). This is Gemserv's third response to the CMA, and in keeping with those responses, we focus on code governance and code administration.

Gemserv agrees with the CMA findings that simply consolidating industry codes would not lead to a positive impact in support of competition<sup>1</sup>. In our initial response, we explained how the sheer weight of market reform is overwhelming many supplier organisations, especially smaller organisations, and there was more that could be done to improve the code governance framework. In that regard, code consolidation of itself seemed to us to miss the root cause.

We also agree with the CMA on the importance of independence, whether this be with regard to Price Comparison Websites, Ofgem's role, or code administrators - this is critical to securing trust in market practices.

However, it is via the delivery of effective competition, where the greatest benefits lie. As evidenced by the CMA<sup>2</sup>, there are risks attached to regulatory interventionist measures. The Retail Market Review (RMR) is an example where regulatory intervention has contributed to an Adverse Effect on Competition (AEC)<sup>3</sup>. Regulation should be a last resort i.e. where competition is (for whatever reason) incapable of delivering the desired outcomes. It is in that regard that Gemserv recommends the CMA consider whether improvements to the competitive market framework for code administration services would be a better option than directing more powers to Ofgem.

Gemserv therefore questions Remedies 18a (licensing code administration) and 18b (Ofgem to control code change timetables). Neither Remedy deals with the competitive market framework for code administration services: indeed, we believe they could make matters worse.

In our response, we examine the effects of the two Remedies and why it is so important to get the code administration services competitive market right; then we comment on the question of Ofgem's objectives and their scope.

### **Remedies within the Notice**

Remedy 18a recommends to DECC to make code administration and/or implementation of code changes a licensable activity, and Remedy 18b grants Ofgem more management powers over code modifications.

It is important to note a degree of control is already exercised by Ofgem upon code administration. The delivery, management, and compliance with codes are embedded obligations within energy market participant licences (granted and monitored by Ofgem). Consequently, Ofgem exercises its executive powers via its compliance duties with respect to suppliers, and network licensees via these licences. In turn, these organisations then drive the necessary regulatory outcomes via agreements, contracts and their membership of codes. The lines of accountability and responsibility are therefore very clearly drawn. In the case of Gemserv, it has obligations in the

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<sup>1</sup> CMA Provisional Findings Report (10th July), Section 11.106, p.460

<sup>2</sup> CMA Provisional Findings Report (10th July), Section 11.10, p.437

<sup>3</sup> CMA Provisional Findings Report (10th July), Section 12.7,(a), p.476

delivery of standards and service levels due to its responsibility as code administrator, and as a consequence of the commercial contract agreements that exist between it and market participants.

Gemserv therefore believes introducing remedies 18a and 18b will be a retrograde step. Indeed, it is our belief that this will impact upon code administrative services in different ways for the different central code bodies.

For code administrators, this will mean the introduction of compliance management regimes with respect to its licensable activities. Difficulties will arise when having to be responsible to the code parties for service delivery, but accountable to Ofgem for compliance. In our view, this will lead to increased costs for code parties, increased reporting needs, and potentially a reduction in code change administration efficiency. This is also likely to lead to stifling innovation and unjustifiably complicating an already complex market structure.

Gemserv also draws to the CMA's attention that the market for code administration services should be deemed a competitive market in its own right. The CMA therefore needs to consider how its Remedies will affect different organisations in different ways, and whether there is a better way, one that is pro-competition and relies less on regulatory intervention. The RMR is a case in point. The CMA has highlighted the benefit of Ofgem's policy approach, stating some measures "*restrict the behaviour of suppliers*", and "*may have distorted competition*"<sup>4</sup>. We therefore question the benefit of introducing a similar prescriptive regulatory regime for code administration. Regulation should only be applied where market failings cannot be addressed by effective competitive market practices, hence regulatory intervention should be a last resort.

Below we explain how code administrators which are delivering competitively tendered services are different to code administrators operating out-with this model, and why remedies should really be focused upon developing a fully contestable code administration service. We also explain further on why accountability is better delivered via a properly functioning market.

### **Competition for Code Administration Services**

In its Notice, the CMA states under Principle 1: "*in assessing remedies, we are mindful of the need to allow market forces to work in order to maximise the benefits to customers*"<sup>5</sup>. In this vein, all Gemserv's code administration work is secured based on a competitive tender basis. As highlighted in our first response to the CMA, this drives efficiencies and innovation, and improves services, reflecting the changing needs of those we serve. We are firmly of the view that all codes should be open to competitive market pressures; indeed, to have some codes that are competitively tendered and some that are not, distorts the incentives that seek to drive efficient change practice across the energy market.

For example, the core service with respect to the Master Registration Agreement (MRA) (since its inception in 1998) has realised a reduction in cost to serve by approximately 55%<sup>6</sup> with a corresponding significant increase in service provision, including the provision of the Green Deal Central Charge database. These benefits have accrued because the MRA is open to competition and has been since 2002. This competitive pressure ensures there is a constant spotlight brought to bear on costs and service quality. Together with the commercial contractual obligations and penalties that underpin the MRA (e.g. loss of contract), Gemserv is incentivised to ensure its code administrative services are subject to a constant review cycle with its clients, meaning that delivery of services remain cost-effective and fit for purpose.

Moreover, the MRA service delivery costs are subject to a year-on-year efficiency reduction to the secretariat contract cost. This commercial focus, plus the threat of losing clients, changes the organisations mind-set from a 'paternal – we know best' approach to 'we need to understand your needs so we can earn the right every day to serve you'. This encourages a rise in quality and sharing of efficiencies – our business survival depends on it.

It is worth noting both Project Nexus and P272 were driven by other code administrators i.e. not Gemserv. With regard to faster switching, changes to the MRA were made more quickly than any other code. An organisation

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<sup>4</sup> CMA Provisional Findings Report (10th July), Summary, Section 140, p.31

<sup>5</sup> CMA Notice of Possible Remedies (7th July), Section 35, p.11

<sup>6</sup> Based MRASCo Limited core costs between 2000 and 2015, adjusted for inflation using Bank of England calculator.

being driven by competitive practices is a nimble organisation - it has to be due to the fact all contracts are competitively tendered - and this is reflected in how we undertake our business.

We would be concerned if, in the course of licensing code administrators, the best practices espoused by those competitive code administrators which operate under commercially negotiated agreements, became more expensive, less effective, and more complex.

There are many organisations which deliver services in the same sector of the industry as Gemserv (including code administration), where the roles undertaken by the organisations are enshrined in licence<sup>7</sup> but, unlike Gemserv, are not solely based on a competitive model. Examples where the approach is reliant upon a non-competitive cost recovery approach include Elexon which administers the Balancing and Settlement Code, Xoserve which looks after the Uniform Network Code, and Electralink which provides the Data Transfer Service. Gemserv's model is unmatched in the code administration arena in that only Gemserv is subject to competitive pressures across all its portfolio. This means that under the current code administration market framework, organisations which do not deliver under competitive models operate at an advantage to those which do, by competing in the same market space (code administration services). Since they are not exposed to the same competitive market pressures to keep down costs, the approach does not lend itself to efficient practices. Plus, the possibility of cross subsidisation between non-contestable and contestable services makes it difficult for competitively based businesses to engage in competing away the inefficiencies as challenger code administration service providers.

CMA has questioned consistency in relation to *'working arrangement and corporate purpose (e.g. not-for-profit vs commercial entities)*<sup>8</sup>. Gemserv prides itself in operating consistently to a range of quality standards (ISO 9001, 14001, 27001, 50001) in the delivery of its services, securing a best in breed philosophy and approach to quality and cost to serve compared with its peers (e.g. other code administrators), and yet does not operate under a not-for-profit model. A focus on efficiency is not necessarily a key focus for 'not-for-profit' structures, where costs can merely be passed through via a cost recovery mechanism. When coupled with operating in a privileged market position i.e. one where an organisation's services are non-contestable, it does not create the right incentives and conditions to drive performance and responsiveness. Competing away inefficiencies and driving innovation are hallmarks of an effective competitive market. The constant threat of losing a contract based on price or quality of service, ensures that organisations remain constantly alert.

Gemserv therefore believes the CMA should focus its remedies upon measures that deliver effective competition not just between energy suppliers, but also the services upon which the market relies heavily upon e.g. code administration services.

The provision for full code administration contestability will encourage the right behaviours in constantly increasing the level of service, while ensuring costs are kept low. The CMA should consider first and foremost these aspects, before seeking out more significant regulatory measures that are likely to lead to unintended consequences.

### **Accountability of Code Administrators**

The CMA comments that code administrators should be more accountable<sup>9</sup>.

The examples the CMA draws upon are with respect to Project Nexus and P272. In both cases these are cited as examples where inordinate delays have occurred, justifying the need for greater accountability to make it better. In both examples, Gemserv agrees with the CMA that the level of complexity associated with these proposals was a significant factor in the time taken to progress them, and there are lessons to be learnt as undue delays have been experienced in both cases.

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<sup>7</sup> *The Balancing and Settlement Code, for example, is delivered in line with the electricity transmission owners' Standard Licence Condition C3.*

<sup>8</sup> *CMA Provisional Findings Report (10th July), Section 11.128, p.465*

<sup>9</sup> *CMA Provisional Findings Report (10th July), Section 11.133, p.466*

Nonetheless, the CMA leaps from the challenge of speeding up the code modification decision making process, to the proposal to make code administrators more accountable via licensing.

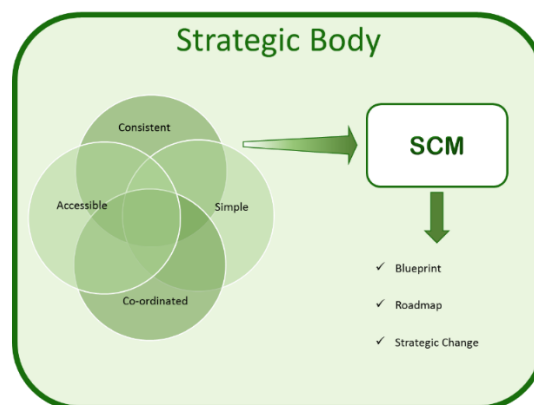
In one sense, we can understand why the CMA might lean towards the licensing of code administration. Ofgem as the regulatory body would be able to drive accountability under a compliance regime with sanctions in the event that outcomes are not achieved.

However, this approach disregards the differing nature of those organisations, the contestable nature of some codes more than others, and cuts across the existing accountability structures. For example, Gemserv is accountable under its contract for the delivery of the Smart Energy Code (SEC), a code whose existence is embedded within licence obligations. As such, Gemserv is, for all intents and purpose, a service delivery organisation operating in accordance with SEC governance practices and procedures. It must execute its code change practices strictly in accordance with the SEC. Failure to do so places it in breach of its contractual obligations. SEC parties drive the SEC administrator to meet licence and regulatory demands made upon them by Ofgem, through their licence. Failure to do so places the code parties in breach of their licence obligations. The lines of accountability are clearly marked out - introducing code administration as a licensable activity introduces a level of complexity which we firmly believe will not satisfy the objective that the remedies seek to achieve.

More fundamentally, the remedies do not deal with the root cause of the issues impacting upon the more complex code changes. There are more fundamental considerations to contend with, which directly impact on innovation and the pace of market development: the approach adopted by Significant Code Reviews (SCRs), and the sheer weight of energy market reform. Both of these generate a significant strain upon organisations that wish to participate within code administration practices with limited resources to do so.

Ofgem have undertaken (and therefore had the experience of) just three SCRs. At this stage, Ofgem instigated a review of the SCR, as it is keen to learn from those experiences. The Ofgem workshop held on 22<sup>nd</sup> July 2015 highlighted that the current SCR process can be significantly improved, thus avoiding more drastic, and the potentially damaging measures advocated by the CMA. A more integrated approach between Ofgem and the industry can be achieved within the SCR process: removing duplication, shortening timescales, and improving the design of the SCR code modifications much earlier in the change process.

In Gemserv's initial response to the CMA and its subsequent response to Ofgem's Open Letter on its Further Review of Industry Code Governance (dated 30<sup>th</sup> June 2015), we explained how a more strategic approach can help. Gemserv propose embedding a set of pre-defined principles into code administration activities, leading to the development of a Standard Code Model (a blueprint for codes to follow). A strategic body could provide oversight and co-ordination between codes in order to achieve consistency, simplicity, accessibility, and co-ordination. Underpinning this model is the concept of competition in code administration, as it is competition which drives behaviours which achieve high value delivery while keeping costs low— see Fig. 1. We believe this will improve accountability, but without the consequences of significant regulatory intervention. We believe there is a key role that Ofgem can play within the Strategic Body to provide the oversight that the CMA seeks.



**Fig. 1 Standard Code Model**

### **Ofgem Objectives**

We agree with the CMA there is a need to ensure Ofgem's principal objectives focus upon that which an economic regulator should give absolute priority. Its objectives would therefore benefit from a much needed clarity of scope.

For example, we have struggled to understand why an economic regulator should find itself as both a regulator as well as a service delivery organisation (E-Serve). This increases its costs overall, introduces potential conflicts of interest, and provides no scope for more efficient market based delivery mechanisms.

Refocusing on its economic regulator role as a fundamental principle will bring much needed clarity of scope. Ensuring objectives are primarily focused around facilitating competition in the market will drive behaviours from market participants which will lead to constant improvement, innovation, exceeding best practice, and ultimately ensuring the best outcome for customers.

### **Conclusion**

In conclusion, Remedies 18a and 18b proposed by the CMA will overcomplicate an already complicated energy market structure. Neither Remedy is easy to deliver: cutting across different codes in different ways, introducing remedies against a somewhat imperfect competitive structure for code administration services, and potentially affecting different code administration organisations to varying extents.

The Remedies will impact upon Gemserv as an organisation and with regard to the services it provides, noting that the developments which flow from the CMA investigation are vital to its current and future business approach.

We would therefore welcome the opportunity to discuss with the CMA our concerns with respect to these Remedies, and the CMA's views on independence and the competitive nature of codes.

Yours sincerely,

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