

Appendix 10.4: Reform of code governance

Introduction

1. We have provisionally concluded that a combination of features of the wholesale and retail gas and electricity markets in GB related to industry code governance give rise to an AEC through limiting innovation and causing the energy markets to fail to keep pace with regulatory developments and other policy objectives. In particular, we are concerned that this provisional AEC has the impact of limiting pro-competitive change. The underlying features of this provisional AEC are the following:
 - (a) Parties' conflicting interests and/or limited incentives to promote and deliver policy changes.
 - (b) Ofgem's insufficient ability to influence the development and implementation phases of a code modification process.
2. In our Remedies Notice, we outlined the aspects of the code governance regime which we considered might need to be reformed to address the AEC that we have provisionally found.
3. We proposed the following three separate remedies that, in our view, each contributed to addressing the underlying features of the provisional AEC set out above:
 - (a) Remedy 18A: recommending to DECC to make code administration and/or implementation of code changes a licensable activity.
 - (b) Remedy 18B: granting Ofgem more powers to project-manage and/or control the timetable of the process of developing and/or implementing code changes.
 - (c) Remedy 18C: appointing an independent code adjudicator to determine which code changes should be adopted in the case of dispute.
4. The purpose of this appendix is to set out further details of the relevant aspects and considerations that informed our approach to designing our revised remedy package. The first part of this appendix gives an overview of what we consider to be the relevant aspects of the current code governance framework. In particular, this includes separate discussions of stakeholders' attributes, the spectrum of code changes that form part of the general portfolio at any given time and how to devise an efficient approach to allocating powers and functions between the various stakeholders. The second part of this appendix provides a brief assessment of certain aspects of the current

governance and modification arrangements which informs the scope of our revised remedy package.

Relevant aspects of the current framework

5. In our provisional findings, we noted that codes contain technical and commercial provisions which require detailed knowledge of the industry to navigate. This, in our view, suggested that industry-led regulation, as a general approach, is appropriate to govern and modify such rules. We considered, however, that the existing governance and modification arrangements failed to ensure that code modifications that are important to consumers' interests and/or competition are developed and implemented efficiently, and created material burdens on parties, in particular smaller ones, which could undermine their incentives to promote changes. We noted that, in view of the number of significant and cross-cutting modification proposals that will need to be implemented in the coming years (for instance to implement the European network codes), and the associated time and resource implications for the regulator and the industry, these issues were likely to be exacerbated if resources were not efficiently prioritised.
6. These inefficiencies in the code modification processes may cause consumer detriment where a change is needed to achieve policy objectives or to support competition and innovation. We are concerned that Ofgem's ability to influence the development and implementation of modification proposals, even in the context of a significant code review (SCR), is insufficient to ensure that industry codes keep pace with market developments or wider policy objectives.
7. It is also worth noting that the first industry codes, ie the Grid Code and Distribution Code (defined in Appendix 11.2 of provisional findings as the technical codes) were set up at the time of privatisation, 25 years ago. However, since then, the GB energy markets have undergone a process of increasing liberalisation which has led to a significant change in the structure and nature of industry participation across those markets. To support that participation, DECC and Ofgem introduced several new 'commercial codes'¹ to ensure a level-playing field that could harbour effective competition.
8. The historical process described above expanded the domain subject to industry-led regulation dramatically. As a result of such expansion, the codes regime, which at privatisation only addressed technical issues, is now an

¹ We define this term in Appendix 11.2 – Codes and regulatory governance to our provisional findings as including the following codes: for gas, the UNC, iGT UNC and SPAA; and, for electricity, the BSC, CUSC, MRA, STC and DCUSA.

increasingly important underlying factor for the interests of competition and consumers within the GB energy markets. In particular, this is due to the increasing number of new entrants, the apparition and development of technologies (both in generation but also retail), and the greater emphasis on objectives such as security of supply and decarbonisation. We also note that these developments have been shaped to some extent by the presence of the codes and their specific governance and modification arrangements.

9. Therefore, we consider it essential to ensure that the code governance regime is fit to keep pace with market developments and with wider policy changes. For that purpose, Ofgem must have sufficient ability (including expertise and powers) to identify areas that require change and ensure that modification proposals that impact on competition and consumers are developed and implemented efficiently. Also, given the wide ranging nature of change (historical and ongoing) experienced by the GB energy markets, Ofgem (and DECC) should in our view also assess on a regular basis whether the scope of industry-led regulation is still appropriate.
10. We also recognised in our provisional findings that the reformed governance arrangements must be capable of efficiently transposing nine European Network Codes into the GB codes regime over the next eight to ten years. This task will be a major and unprecedented challenge for the codes regime. Bearing that in mind, Ofgem's alternative remedy proposal (described above in paragraphs 7 and 8), can be taken as an indication of the extent to which the current governance arrangements may need to change in order to meet that challenge.

Relevant considerations and our approach to designing code governance arrangements

Resources, expertise and independence of relevant stakeholders

11. This section describes our assessment of the resource and expertise of Ofgem, industry participants and code bodies, and their ability and incentives to act independently from commercial interests.

Ofgem

12. Despite the underlying importance of the codes to the functioning of the energy sector, it is in fact the industry that 'owns' the codes.² Indeed, Ofgem

² For each code, there are SLCs that require certain licensees (typically, the relevant network owners) to review/maintain in force each of the codes.

does not have direct responsibilities to manage codes and only interacts with the codes in a limited number of contexts, such as when undertaking an SCR (its 'gap-filling function') or deciding whether to approve a material code change that has been developed by the industry (its 'gatekeeper function').³ As a consequence, it has no incentive to devote significant resource to systematically developing its knowledge and understanding of the substantive provisions set out in codes.

13. A further issue with this role is that it typically requires Ofgem to analyse the code change in question in isolation, rather than as part of a package of related code changes or in relation to any sort of strategic work plan. As a result, Ofgem's substantive codes expertise has developed in piecemeal fashion and as a result it lacks a detailed understanding of certain issues, such as how the codes interact and how to implement significant policy decisions through a package of related code changes.
14. This approach reflects policy decisions that trace back to the time of privatisation, when government decided to reserve certain areas of the energy sector (ie those covered by the codes) for industry-led regulation.⁴ As noted above, the scope of the codes has increased greatly since privatisation, with this expansion reflecting the multifaceted changes experienced by the industry (see paragraphs 7 and 8 above). However, the general approach to regulating the codes has never changed, with the outcome that no government entity has ever needed to invest the resources necessary to develop a detailed understanding of the technical subjects, and substantive provisions, that the codes cover.
15. By contrast, Ofgem has significant expertise in regulating the energy sector and assessing the impact of technical, legal or commercial changes on competition and consumers.
16. In terms of independence, as the designated National Regulatory Authority for the purposes of the EU Third Package, Ofgem is subject to strict independence requirements (ie independence from both political and market

³ Pursuant to that function, Ofgem must review 'on the merits' each material code change that is raised by the industry. The main disadvantage of this process is that, since Ofgem only has limited ability to initiate changes itself (eg through the SCR process, which Ofgem has used only in three occasions since it gained this power in 2010), its scrutiny as part of its gatekeeper function has never been applied to a significant proportion of the areas governed by codes, whilst other areas have not been reviewed for a number of years. As a result, Ofgem has not had the opportunity, nor the incentive, to build a comprehensive understanding of whether significant areas of the codes are functioning appropriately.

⁴ Certain codes (namely, the upstream codes: the distribution code and the grid code) existed prior to privatisation and thus represented the collected knowledge of industry in relation to operating standards and other detailed rules. Government permitted National Grid, which owned and operated those codes prior to privatisation, to continue its role in relation to the codes following privatisation.

forces). In addition, Ofgem's statutory basis establishes that its principal objective is to further the interests of (existing and future) consumers.

17. Moreover, Ofgem has actively and holistically developed its expertise in relation to the code governance arrangements in place under each of the codes. Ofgem launched its Code Governance Review in 2007 and following implementation in 2010 of a first set of reforms, has monitored the operation of the governance arrangements closely and on an ongoing basis.⁵ On 23 October 2015, it published initial proposals for a further series of incremental reforms of the governance regime, indicating that its measures to date have not addressed the underlying issues it first identified in 2010.
18. The functions described above have enabled Ofgem to acquire a system-level understanding of the code governance arrangements and an in-depth understanding of certain substantive code provisions (ie as a result of undertaking its gatekeeper and gap-filling functions). However, Ofgem has submitted to us 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 on an ongoing basis. In addition, Ofgem has indicated that tools such as the SCR have been used in the absence of alternatives for delivering strategic code change. We also consider that, compared to the industry and code administrators, Ofgem has limited knowledge of certain code provisions and in particular those provisions that have not been the subject of an SCR process or submitted to Ofgem by a code panel. In light of these factors, we consider that Ofgem may have insufficient capacity and incentives to take a prominent role in drafting and implementing code changes.
19. That being said, as the regulator in charge of pursuing the best interests of existing and future consumers, it is essential that Ofgem not only performs its gatekeeper function, but also considers whether the code governance regime is fit for purpose and whether the code changes that are necessary for the codes to keep pace with market developments and wider policy changes are raised, developed and implemented in a timely manner. To do so, it needs to have an adequate understanding of the substantive provisions of codes, a clear direction for code governance and the ability to influence the initiation and development of code changes.

⁵ Recently, in May 2015, it published an open letter to industry in which it acknowledged that its previous interventions had not led to a well-functioning regime and consulted on a range of further reforms.

Industry

20. Our analysis, which is supported by stakeholder responses (including Ofgem's), indicates that industry participants collectively control the large majority of substantive and technical expertise needed to activate and drive forward code development (ie to initiate and assess modification proposals). We note that due to this reality, and the limited nature of Ofgem's code specific expertise, it is essential to maintain industry participants' incentives to engage in the governance of codes.
21. However, in our provisional findings, we identified industry participants' conflicting interests as an underlying feature of the inefficiency of the current code governance arrangements. In general, we acknowledged that all industry participants, whether engaging with the codes on a voluntary or required basis, are subject to the influence of commercial interests to some degree (although when industry participants act through code panels they must act on a collective rather than an individual basis, and must comply with procedural safeguards including the need to act by majority and, in some contexts, a duty of impartiality).
22. It is also important to note that industry participants' resources, expertise and incentives to contribute to the codes vary across a wide spectrum, ranging from the Six Large Energy Firms through the mid-tiers and finally to the smallest independent suppliers.⁶ Such variance is significant because the decision to engage with various aspects of the code governance arrangements can be costly and, in some cases (eg participation in code panels), may require the ability to accept the prospect of indefinite financial returns in the long term. As the majority of industry participants are under no obligation to engage in the codes,⁷ most parties will tend to restrict their engagement in the codes to processes that may lead to a tangible impact on their own respective business models. This is most likely to be the case for smaller parties, which are under that the greatest pressure to employ their scarce resources efficiently. Although we believe code administrators mitigate this issue somewhat by assisting small market participants through their role as 'critical friends', the sheer number of codes and code changes currently limit the level of engagement of smaller parties.

⁶ We note that Ofgem has previously intervened to reform the role of code administrators so that it is more focused on facilitating engagement by smaller companies in the code arrangements. We note further that Ofgem has recognised that its previous interventions in this context have not fully addressed the issue of engagement by small parties.

⁷ Only a minority of licensees (typically network owners) are subject to licence conditions that contain a general obligation to maintain in force or review the functioning of one or more codes.

23. Regardless of industry participants' specific incentives to engage in the code governance arrangements, we recognise that commercial realities limit the likely output of that engagement. In particular, we note that code objectives, and the duties of industry participants within this context, do not cover the broad spectrum of objectives that Ofgem must achieve. It is therefore essential to ensure that sufficient supervision is in place with a view to pursuing consumers' best interests.
24. In light of the above, we believe that it is essential to maintain industry participants' incentives to engage in the governance of codes, and to contribute their expertise and detailed understanding of codes. However, safeguards need to be in place, to ensure that the voice of all industry participants are heard, and that the interests of consumers are taken into consideration.

Code bodies (code administrators and delivery bodies)

25. Similar to the situation that exists for the industry, there is a wide disparity across the current code administrators in relation to resource capacity. We noted in our provisional findings that this disparity is mainly attributable to the fact that there is no common funding mechanism for code administrators. The lack of a common funding mechanism is partly explained by the fact that code administrators perform a different set of functions (additional to the core secretarial function) under each of the codes and partly by the fact that code administrators are not consistently subject to competitive constraints for their services.
26. As the core function of each of the code administrators is secretarial in nature it follows that, in general, most code administrators have greatest expertise in relation to the details of the procedures and governance arrangements that apply to the codes which they administer. However, as noted above, some of the code administrators perform an additional range of substantive functions and, as a result, can validly claim to have developed unique and essential expertise in certain subjects, such as how code parties or categories of code party interact with a code at the aggregate level.
27. It is difficult to reach a general conclusion in relation to the ability of code administrators to act independently from commercial interests, due to the different legal bases and funding arrangements that apply to those entities. Certain code administrators (ie National Grid and Elexon) have clear links with the industry due to their corporate identity (Elexon is a wholly owned

subsidiary of National Grid).⁸ As noted above, there is no common funding arrangement applicable across the code administrators. We note that the CACoP, which Ofgem introduced in order to harmonise best practices across code administrators, does not prescribe any particular behaviour to ensure the independence of code administrators.

28. Code administrators occupy a rough ‘middle ground’ between Ofgem and the industry. In our view, they should seek to act independently from the industry’s commercial interests. In general, because of the respective ‘strengths and weaknesses’ of Ofgem and industry participants highlighted above, we believe that the key future role of code administrators (or similar intermediaries) is to collaborate with those stakeholders in order to leverage these strengths and counteract these weaknesses.

Materiality and complexity of modification proposals

29. As noted above, the scope of industry-led regulation has expanded over time and now covers areas that are material to consumers’ interests and competition. For instance, within the context of this market investigation, we have assessed the impact of code changes addressing issues such as transmission losses, half-hourly settlement and the electricity balancing mechanism. We consider that such modification proposals, because of their significant impact on consumers’ interests and competition, should be allocated greater resources from stakeholders, including early involvement by Ofgem, as part of its role to pursue consumers’ best interests.
30. We would expect a well-functioning system to ensure that the level of involvement by each category of stakeholder in the development of a given MP reflects the relative importance of that MP (to consumers and/or competition), taking into consideration the respective resources and expertise of the various stakeholders, and their independence from commercial interests. In particular, we would expect Ofgem’s involvement in this context to be proportionate to the materiality of each MP. We consider that modification proposals which are material to consumers’ interests and competition require more robust assessment, and therefore resources from the industry (either directly – eg from the proponent of an MP – or indirectly – through code administrators funded by industry). In our view, a well-functioning system should recognise the different ways that private and public stakeholders choose to allocate their own resource.

⁸ We note that National Grid is also a licensee and is therefore subject to direct oversight by Ofgem.

31. Similarly, special attention needs to be given to complex modification proposals, which require code modifications to be made to more than one code in order to be effective. Failure to coordinate all necessary changes may lead to delayed implementation, as has been the case, for instance, within the context of MP P272 (see paragraph 11.67 of provisional findings). In practice, material changes will often impact more than one code, and therefore require changes across multiple codes to be tightly coordinated.
32. Failures in coordination may be caused either by:
 - (a) a failure to identify in a timely manner the need for consequential change(s); or
 - (b) inadequate coordination between two parallel processes.
33. One of the principal conclusions of Ofgem's Code Governance Review was that the code arrangements existing at the time did not adequately facilitate complex, cross-code changes. As a matter of policy, Ofgem chose to address this identified weakness by establishing the SCR process and strengthening the role of the code administrators rather than by altering the system of change coordination measures that exist within most of the industry codes. These mechanisms, described in our provisional findings (see paragraphs 11.135 to 11.139 of provisional findings), although helpful, may not be fully effective in addressing the two issues identified above.
34. Assuming that a codes regime contains a multiplicity of codes, a well-functioning governance system should provide adequate mechanisms intended to both identify potential cross-code impacts and coordinate related 'packages' of code changes.

Our approach to allocating powers and responsibilities effectively

35. As a form of conclusion, we consider that Ofgem has a critical duty to ensure that the regulatory framework, including codes, works in the best interests of consumers but that its involvement in the codes should be targeted so as to utilise its limited codes expertise efficiently. Conversely, industry participants have extensive resources and expertise in this area (although small participants may be constrained to some degree), but as they are primarily driven by individual commercial interests their involvement should be subject to appropriate supervision.
36. It is also worth highlighting that the general scarcity of available resource and expertise makes it imperative that all available capacity is efficiently allocated across the portfolio of ongoing code changes. Ofgem and small parties face the greatest capacity constraints and it is therefore important to ensure that

the governance and modification arrangements are structured to support efficient engagement by those entities.

37. In our view, two key changes could enable the governance arrangements to achieve an efficient allocation of powers and responsibilities between the relevant stakeholders: firstly, reinforcing the role of code bodies; and, secondly, improving the prioritisation mechanisms for modification proposals.
38. Code administrators (or similar entities sitting between Ofgem and the industry) currently play a number of different roles in different contexts and, if raised to the same level of productivity and performance, could represent a significant source of untapped capacity that would ease pressure elsewhere in the system. We are however concerned that, currently, code administrators may not be perceived as fully independent from certain commercial interests (eg due to their shareholding).
39. Code governance arrangements should provide adequate mechanisms intended to aid the prioritisation of modification proposals, in particular in light of their possible impacts on consumers' interests and competition. Prioritisation of an MP can mean that Ofgem (but also industry) resources are focused on those areas that require greater attention, whilst changes that are unlikely to impact consumers' interests and competition benefit from simpler, streamlined processes.
40. Under an efficient system, and in light of the above, prioritisation mechanisms would allocate substantial resource and expertise to develop modification proposals in a way that is proportionate to the significance (ie are likely to have a material impact on consumers' interests and competition) or complexity (eg are likely to require cross-code changes) of the MP in question. To ensure that such analysis is performed adequately, we would expect governance arrangements to require that Ofgem's involvement is adapted to the materiality of the MP, in order to ensure that the interests of consumers are duly taken into consideration, and to facilitate the transition from the development phase (led by the industry) to the approval phase (falling into Ofgem's remit). Similarly, we would expect more resources, either from the industry participants or from code administrators, to be allocated to the evaluation of such modification proposals as well as to end-to-end project management.
41. By contrast, efficient mechanisms would de-prioritise the least significant (ie non-material) modification proposals by limiting resources allocated to these and the involvement of Ofgem.

42. In our view, the current regime includes several mechanisms that seek to prioritise modification proposals in the ways described above. For instance, certain codes contain a mechanism to enable modification proposals that deal with urgent issues to be fast-tracked by code panels through a streamlined procedure. The SCR process provides a means to ensure sufficient resourcing and oversight for the most significant and complex modification proposals. Conversely, the self-governance scheme allows non-material modification proposals to be delivered efficiently with minimal resources expended on project management and evaluation. However, considering the different degrees of materiality and impacts of modification proposals, these mechanisms are in our view insufficient, as discussed further below.
43. In the section below we assess certain aspects of the current code governance processes and identify particular areas where changes are needed.

Assessment of current processes and identification of remedy

44. As part of our provisional findings, we acknowledged that Ofgem’s prior interventions through the Code Governance Review seem to have facilitated a more efficient allocation of resources between Ofgem, the industry and the code bodies. In particular, Ofgem made the following reforms to the code modification and governance arrangements through the Code Governance Review:
- (a) Introduction of the self-governance procedures (fast track and regular), to provide a streamlined approval process for non-material code changes.
 - (b) Creation of the SCR process, as a means for it to ensure sufficient resourcing, oversight and timely implementation of strategically important and complex code changes.
 - (c) Introduction of other ancillary mechanisms, and in particular measures intended to improve the quality of analysis performed during the development stage (Ofgem’s ‘send-back’ powers) and harmonise the performance of code administrators (the CACoP).
45. Following the changes described above, modification proposals can be developed through the three modification routes set out in Table 1 below.

Table 1: Current modification routes

	<i>Process</i>		
<i>Stage</i>	<i>Self-governance</i>	<i>Ordinary</i>	<i>SCR</i>
Initiation	Industry	Industry	Ofgem

Development	Industry	Industry	Two sequential stages: first Ofgem and then industry
Approval	Industry	Ofgem	Ofgem
Implementation	CAs*/ delivery bodies/ industry	CAs/ delivery bodies/ industry	CAs/ delivery bodies/ industry

Source: CMA.

*CAs = code administrators.

46. We discuss below our updated assessment of the functioning of each of the three main modification ‘routes’, and set out how we consider the self-governance and a revised (and expanded) ordinary process to be capable of achieving the aim of this remedy package. In particular, this assessment seeks to take into account parties’ responses since provisional findings and our overarching approach discussed above (see paragraphs 21 to 52).

Self-governance

47. As part of its Code Governance Review reforms, Ofgem introduced the self-governance scheme to streamline the delivery of code changes deemed non-material to the industry, consumers’ interests and/or competition. Under the self-governance scheme, eligible code changes can be implemented without the code panel having to first submit the change to Ofgem for formal approval.⁹ There are two main efficiency gains related to the existence of the self-governance scheme: firstly, there are straightforward efficiencies achieved from truncating the process for these changes; and, secondly, it enables Ofgem to allocate its own resource more efficiently, ie by focusing its resource on the evaluation of material code changes.
48. A 2015 Ofgem-run survey indicates that 30% of all modification proposals are now processed through either the fast-track or regular self-governance procedure. In our view, this indicates that the introduction of the self-governance scheme has already resulted in significant efficiency gains across the codes regime. However, we consider that there remains scope for further efficiency gains to be achieved as a result of increased usage of that scheme.
49. As a basis for the above claim, we note Ofgem’s analysis of all code changes processed from May 2014 to May 2015, which concluded that the usage rate of self-governance during that period could have been as high as 50% if each of the code panels had interpreted the materiality criterion in line with Ofgem’s understanding of that concept. Ofgem has stated that the discrepancy it has identified between the actual and possible usage rate is likely due to code panels taking an overly conservative approach in making

⁹ Ofgem has the ability to overturn a code panel decision to qualify an MP as eligible for self-governance.

such determinations, which is likely caused by the code panels' lack of familiarity with the process.

50. In our view, maximising the sensible usage of the self-governance regime is an important part of improving the overall efficiency of the codes regime. In accordance with Ofgem's own analysis, we expect that this objective will be achieved partly as a natural result of code panels gaining experience with the self-governance process over time. However, we consider that Ofgem could accelerate the process by which code panels arrive at the 'correct' approach to interpreting the materiality criterion by publishing guidance on this subject. Ofgem should seek input from each of the code panels and code administrators in developing this guidance to ensure that the proposed guidance is of practical use to those entities. Therefore, Ofgem should publish guidance, developed in the manner described above, on how the materiality criterion should be interpreted for the purposes of self-governance.¹⁰
51. As a separate matter, we note that as part of its ongoing Code Governance Review, Ofgem is considering making the self-governance process the default option to process any given code change that is not the subject of an SCR. This change would effectively reverse the evaluation undertaken to determine whether an MP is eligible for self-governance. Rather than setting out reasons for why a particular MP is not material (and thus eligible for self-governance in the current system), code panels would instead have to reach a decision that a particular MP is material in order for it to become eligible to be processed through the ordinary modification process.
52. In our view, this change could help to overcome the current conservative approach adopted by code panels in interpreting the materiality criterion. However, we recognise that there is a risk of code panels taking an equally conservative approach in relation to submitting code changes for the ordinary modification process and that, as a result, the usage rate of the self-governance could be (significantly) higher than the 50% that Ofgem considers appropriate. This, in effect, would excessively restrict Ofgem's role in code governance, which we consider inappropriate. Therefore, regardless of which modification 'route' is established as the default option, we believe that Ofgem should provide guidance on how to interpret the materiality criterion in order to achieve an efficient usage rate for self-governance and monitor compliance with that guidance.

¹⁰ We note that as part of Ofgem's ongoing Code Governance Review it is consulting on an initial proposal to require code panels and code administrators to produce guidance on how they will interpret the materiality criterion.

Our assessment

53. We consider that the self-governance scheme has improved the overall efficiency of the code regime. However, for the reasons set out above, we believe that Ofgem should publish, following appropriate consultation of the industry, a new guidance document on the interpretation of the materiality criterion within the context of the self-governance process.

Ordinary modification and SCR processes

54. Under the current ordinary modification process, each MP must pass through four sequential stages: initiation, development, approval and implementation. The development stage can be further broken down into several essential functions, including: prioritisation of modification proposals, the performance of analysis, project management (which is also an essential function in the context of the implementation stage) and the drafting of the modification report (and the legal text). Modification proposals initiated through the SCR process must also pass through the four main stages described above. However, in addition to those stages, the SCR process inserts prior to the initiation stage an Ofgem-led analysis stage which includes an exploratory assessment of the underlying issues.
55. The current ordinary modification process allocates powers and responsibilities to the industry to enable industry participants, acting either individually or collectively, to perform the majority of all essential functions across the four main modification stages. Notable exceptions to this approach are that code administrators (and delivery bodies) conduct a limited form of project management during the development and implementation stages and Ofgem performs the gatekeeper function in relation to material code changes during the approval stage.
56. Within the context of the SCR process, and unlike for the ordinary process, Ofgem provides early scoping of issues, performs analysis of the area of regulation that requires a code modification, and can also control a limited number of procedural elements. However, after Ofgem has performed its analysis, the MP must then be raised by an industry participant (pursuant to an Ofgem-issued direction) and go through all the stages of the ordinary procedure.

Our assessment

57. In light of our provisional findings, updated analysis of stakeholders' capacity and parties' responses, we consider that the following aspects of the current

ordinary and SCR processes are a cause of inefficiency, which in turn lead to delays in the delivery of code changes:

- (a) The absence of 'strategic principles' for identifying and prioritising code changes that are necessary to keep pace with regulatory developments and other policy objectives. The lack of such principles means that there is no mechanism to distinguish between the roughly 70% of code changes that pass through the ordinary process, ie those code changes that meet a basic definition of materiality. As the possible spectrum of materiality in this context is extremely broad, the absence of overarching principles within the current system increases the likelihood that stakeholders allocate their (scarce) resources inefficiently and in an inconsistent manner across codes. We note that under the current regime Ofgem can only provide industry with signals as to its overarching code development objectives and priorities through the use of its SCR powers. However, in our view, Ofgem's utilisation of the SCR process can only provide such signals in an ad hoc, piecemeal fashion, and puts a lot of pressure on Ofgem's resources due to the requirement to carry out extensive analysis. This type of involvement may be appropriate for the most important (and exceptional) modification proposals, eg those initiated through the SCR process. Our concern is that, short of using the resource-intensive SCR process (see below), Ofgem has no other mechanism to assess the materiality of modification proposals and adapt the level of its involvement in the development of any given MP. The combination of this restricted choice framework and the sheer number of modification proposals that go through the ordinary process means that, in practice, Ofgem usually does not get involved in the development of ordinary modification proposals until a recommendation is made by a code panel. This is a concern because any substantive involvement by Ofgem at this stage is likely to cause avoidable delay in the process. Therefore, we consider that the current regime is missing a mechanism that establishes an overarching, cross-code framework for assessing the materiality of code changes, and for adapting accordingly the level of resources and (early) involvement from Ofgem.
- (b) **Insufficient coordination between Ofgem and industry.** Ofgem has been forced to use its send back powers on several occasions following its receipt of a recommendation made by a code panel at the end of the industry-led development stage. In each instance, we consider such action by Ofgem to be an indication that it was not satisfied with the scope or depth of the analysis carried out by the industry. This suggests that there is a general lack of oversight by Ofgem over the analysis performed by modification work groups, which, in turn, may lead to the duplication of

analysis and therefore to additional costs and delays. Currently, Ofgem can only influence the development stage formally through its SCR powers, which, as noted above, is a resource-intensive process that is not likely to be an appropriate option in most cases. Whilst Ofgem could engage informally with the industry, the frequent use of its send back powers indicates that Ofgem has insufficient ability and/or incentives to engage early in the development stage in order to improve the scoping of analysis.

- (c) **The excessive length of the typical SCR process that prevents Ofgem from initiating an SCR in all appropriate instances.** In our provisional findings, we noted three main issues with the current SCR process: firstly, the SCR processes so far have taken much longer to complete (40 months on average) than Ofgem's anticipated timeframe (18 months); secondly, Ofgem lacks the ability to drive forward SCRs that become 'stuck' during the industry-led stages (eg by mandating timetables); and, thirdly, Ofgem has only exercised its SCR powers on four occasions since it established the process in 2010, which has forced several significant modification proposals (eg Project Nexus and half-hourly settlement) to pass through the ordinary process, with the result that they have not been adequately resourced or project managed, which has ultimately caused delays in the delivery of those modification proposals. Since our provisional findings, we have identified that Ofgem does not have significant expertise or resource to devote to codes issues and, as a result, it is constrained from utilising the SCR process efficiently. This is because, in its current format, each SCR process is rigidly resource intensive: once Ofgem launches an SCR, it in effect commits to perform the 'SCR gate' consultation, which takes six weeks, as well as all required analysis to enable it to provide the industry with meaningful SCR directions, which according to its own published guidance will typically take around a year.
- (d) **Insufficient project management of the development and implementation stages of strategically important or complex modification proposals.** Across the case studies that we included as part of our provisional findings report, we observed several instances in which avoidable delays occurred during the development and implementation stages as a result of insufficiently robust project management. Code panels have some power to provide oversight (eg by approving the terms of reference for modification work groups), but they are (perceived as) insufficiently independent from the industry to be relied upon to provide robust project management. Code administrators, meanwhile, do perform a limited form of project management (eg by

drafting the terms of reference and providing secretarial support), but are constrained by their lack of formal powers to compel other code parties and, with few exceptions, by their resources. We note that some code administrators may have insufficient incentives and/or ability to project manage modification proposals. In the context of some codes, project management of modification proposals by the code administrator is made possible due to the existence of a project assurance framework or a contractual arrangement between the code administrator and the relevant code parties. In those circumstances, the project assurance framework or contractual arrangement generally creates an obligation on the code administrator to carry out project management functions while obliging the relevant code parties to facilitate the code administrators' fulfilment of that obligation. However, and as noted above, for several codes there are no such arrangements in place. In any event, the use of project assurance frameworks or contractual arrangements has limitations because it does not grant Ofgem the ability to hold any party directly accountable for its performance. We also recognise that, to a degree, centralised project management is hampered by the inherently fragmented nature of the implementation process. This is due to the fact that each code party (ie system owner) is individually responsible for transposing the legal text of an MP into its own relevant systems.

- (e) **Ofgem's limited ability to influence, and hold accountable, entities responsible for the development and implementation of code changes.** Outside of the context of the initial stage of the SCR process, in which Ofgem directly oversees progress, development and implementation is left to the code panels, individual code parties and code administrators, with Ofgem's role limited to its gatekeeper function. Given this arrangement, we view it as a particular cause for concern that Ofgem can hold neither code panels nor code administrators accountable for their performance in this context. Code panels and code administrators are essentially unlicensed private entities, with the result that Ofgem has limited powers to direct them and to sanction them for failing to progress or implement code changes on a timely basis. In relation to code panels, Ofgem could in theory seek to hold licensed employers of code panel members responsible, though in practice this course of action would be fraught with difficulty. We also recognise that an additional complicating factor in relation to code administrators is that there is no common approach to funding or contracting code administration services. A separate cause for concern is that Ofgem does not seem to be willing, in certain circumstances, to hold individual code parties accountable for failing to implement approved modification proposals in a timely manner. An illustration of this issue emerged in the context of the implementation

of Project Nexus, where the lack of established protocol and the sheer number of implicated code parties appeared to deter Ofgem from taking enforcement action against non-performing parties. However, we note that RWE npower has raised an MP seeking to establish an accountability mechanism within the UNC (ie which does not require Ofgem enforcement) for the purpose of incentivising Gas Transporters to ensure their agent, Xoserve, completes implementation of Project Nexus by the proposed deadline. We have not formed a view on this particular MP, but consider it necessary to ensure that code parties have sufficient incentives to implement approved changes in a timely manner. We believe that the industry and code administrators may have a role in identifying circumstances where additional resources (eg the appointment of an external project manager) are required to ensure timely implementation. We also believe that mechanisms should be in place to monitor code parties' compliance with their obligations, in order to facilitate Ofgem enforcement where necessary.

- (f) **The lack of a central entity capable of identifying, and coordinating the development of, cross-code changes.** Under the current arrangements, the two principal mechanisms in place to ensure the coordination of cross-code changes are the SCR process and the non-binding obligations placed on code administrators by Principles 1 and 13 of the CACoP to contact one another to note cross-code impacts. We note that each of these mechanisms is ad hoc by nature; and that the two mechanisms together do not combine to provide a centralised, systematic approach to coordination. Moreover, the current system places primary responsibility for identifying cross-code impacts on Ofgem and code administrators, and does not utilise industry participants' greater expertise to perform this function.

Proposed revised remedy package

58. In light of our general approach to designing this proposed revised remedy package (set out in paragraphs 11 to 42 above and Section 10), our assessment of certain relevant aspects of the current framework (set out in paragraphs 43 to 56 above) and parties' submissions to us (see Section 10) we have decided to move away from the original remedies that we proposed in our Remedies Notice. We have set out our revised remedy package in Section 10.