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Your Ref: P207 IAR: PT
Our Ref: IND/COD/MODS/216
Direct Dial: 020 7901 7355
Email: mark.feather@ofgem.gov.uk

30 January 2007

Dear Nick,

Request for provisional thinking in regard to Modification Proposal P207

Thank you for your letter dated 12 January 2007.

On 5 January 2007, the Modification Group issued an interim report setting out its provisional findings in respect of Modification Proposal P207, 'Introduction of a new Governance Regime to allow a risk based Performance Assurance Framework (PAF) to be utilised and reinforce the effectiveness of the current PAF' (the "Interim Report").

Pursuant to the BSC, section F, paragraph 2.6.10(b), the Panel may seek our views as to whether the findings of the Interim Report "are consistent with [our] provisional thinking in respect thereof". Such a request was contained in your letter of 12 January and is stated to "replace section 4 of the Interim Report".

This letter sets out our current views as to whether the provisional findings of the Modifications Group contained in the Interim Report are consistent with our provisional thinking in respect of P207. In view of the provisional nature of this exercise, we of course reserve our rights generally including the right to modify our views as the modification process progresses and with regard to our response to the recommendations in the Panel's Modification Report on P207.

The Panel has sought our views on five questions:

1) Does the Authority think there is a role for it to be part of the appeal mechanism when considering individual Party Risk Management Plans?

2) Does the Authority believe that its role in the appeal mechanism should relate to appeals against the process by which the appellant's Risk Management Plans have been produced?

3) Does the Authority believe that its role in the appeal mechanism should relate to appeals against individual elements contained in the appellant's Risk Management Plan?

4) Are there any other comments that the Authority wishes to make on the suggested criteria against which a Party would be able to escalate an appeal to it?

5) Does the Authority believe that it is appropriate for BSC Panel Committees responsible for risk evaluation and risk assurance under P207 to be formed of members that represent their company's views, or the views of a constituency of a participant type?

Our provisional thinking on these matters is set out below. Although our answer to your first question can be summarised as that we do not consider that there is a role for the Authority in the appeals mechanism for individual Risk Management Plans (RMPs), we have chosen to additionally answer your second, third and fourth questions.

This is because although each of these questions pre-suppose that the Authority would have a role in the appeals mechanism and pertain to that role, we consider that they highlight some important issues and inconsistencies in the types of decisions that are envisaged as being eligible for appeal. Our views on these subcategories of RMP appeal differ: in some areas we are sympathetic to the arguments for a right of appeal existing but have not been convinced that we should form part of this process; whilst in other areas we are not convinced that any right of appeal should exist. Given that the model developed by the modification group envisages two appellate bodies, we consider that providing visibility on our views on these subcategories could help the Panel and industry to understand whether these issues may also exist for the other appellate body (the Panel).

We answer your first four questions in reverse order, as we consider that it is important to distinguish up-front the two very different kinds of appeals that appear to be envisaged by the modification group.

Your fourth question: Are there any [other] comments that the Authority wishes to make on the suggested criteria against which a Party would be able to escalate an appeal to it?

We note that two tiers of appeal are contemplated, based on common grounds of appeal. First, an appeal to the Panel against a decision of the Risk Assurance Board (RAB). Second, a further right of appeal to the Authority, encompassing the RAB's and/or the Panel's decisions.

It has been suggested that an appeal to the Panel and, thereafter, to the Authority should be allowed where one of four grounds is met[1]. These four criteria do not share a consistent theme.

The first three criteria are that:

[1] We note that the grounds of appeal (as expressed in the Interim Report) are currently drafted in a way that suggests that an appellant could only rely on one of the four grounds for any appeal that it lodged, rather than potentially several (i.e. it is an "or" clause, rather than an "and/or" clause). We would welcome clarity in the final Modification Report on whether it is intended that an appeal on multiple grounds be admissible. The answer to that question may have a knock-on impact on the complexity, and duration, of any appeals.

- the Panel and/or the RAB has not followed the correct procedures under the Code or Code Subsidiary Document; or
- the Panel and/or the RAB has given undue weight to particular evidence submitted or to the lack of particular evidence submitted; or
- the Panel and/or the RAB has misinterpreted all or some of the evidence submitted.

These three criteria essentially relate to alleged procedural failures in the processing of the Party's RMP, and we refer to appeals based on these grounds as *"procedural appeals"* for the remainder of this letter. We interpret your second question as relating to the appropriateness of procedural appeals.

The final ground for appeal is conceptually very different:

- If the Party reasonably believes or is advised that the decision of the RAB will or is likely to unfairly prejudice the interests (including both commercial and BSC interests (however BSC interests take precedence)) of the Party[2].

This fourth ground is essentially a commercial one – the Party is not disputing that its Risk Management Plan has been formulated or processed correctly; it simply believes that complying with it will or is likely to be prejudicial to its interests, including its commercial interests. We refer to appeals based on this ground as *"commercial appeals"*[3] for the remainder of this letter. We interpret your third question as relating to the appropriateness of commercial appeals.

Your third question: Does the Authority believe that its role in the appeal mechanism should relate to appeals against individual elements contained in the appellant's Risk Management Plan?

We do not consider that the Authority (or, for that matter, the Panel) should have a role in considering *commercial appeals* of RMPs.

Licence obligations require Parties to comply with the code. Each Risk Management Plan would be seeking to bring the associated Party into (or toward) compliance with all (or some) requirements of the code and, by extension, that Party's licence.

A Party may entirely remove the risk of receiving an RMP that it considers could be unfavourable to it by complying with the code. It is a binding contract. It is incumbent on Parties to ensure that they comply with it. Parties should be avoiding adopting the approach that compliance is conditional or optional.

The proposed approach may also diminish transparency and consistency by effectively creating parallel governance: what the code says you should do; and what appeals precedent says it is reasonable for you to do.

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[2] A shortened version of this condition, *'The Party feels that they have been unfairly prejudiced'*, is used in the first attachment to your letter. For the purposes of our answer we have used the longer wording contained within section 2.2.4 of the Interim Report because we understand that this is the wording currently agreed by the Modification Group.

[3] Although this appeals filter cites both "commercial" and "BSC" interests, we treat the two as interchangeable for the purposes of this letter. It should be borne in mind that the BSC is a binding contract that affects the commercial interests of its signatories.

The wording of the commercial appeals trigger has some similarities to that incorporated within the process by which committee decisions made under the Master Registration Agreement (MRA) may be appealed to us. But it is not clear that the MRA model is an informative precedent for the appeals mechanism envisaged by P207 because the nature of the code; the role of the decision makers within it (both committee and Ofgem); and the scope of decisions that may be appealed fundamentally differs. The BSC is essentially a commercial code with independent committees where all rule changes are subject to regulatory decision, whilst the MRA is essentially a technical code with representative committees where most rule changes are subject to self-governance by industry. Whilst the MRA appeals model may in practice allow for a committee compliance decision to be escalated to the regulator, its role is considerably broader than compliance: for example; allowing for decisions to amend the code to be challenged.

We have a general concern that introducing a dedicated role for the Authority as an appellate body on BSC compliance could lead to conflict with our responsibilities as licence enforcer on code compliance. A commercial appeal would essentially be a request for dispensation against complying with the code and with licence conditions.

The market is dynamic and we fully accept that there will be occasions where the pace of change may mean that applying an existing obligation to one, some or all signatories is no longer appropriate. But we consider that the code already contains provisions that allow a Party to demonstrate that a code provision is unreasonable and should be removed or varied: the modifications process.

The existing modification route does not create the risk of parallel governance inherent in the proposed commercial appeals route. It also results in the transparent and consistent application of rules across the market because it has multilateral effect, rather than simply affecting the appellant.

Your second question: Does the Authority believe that its role in the appeal mechanism should relate to appeals against the process by which the appellant's Risk Management Plans have been produced?

Parties are materially affected by the provisions of the code and have a right to be confident that it is being correctly and fairly applied in accordance with the relevant procedural rules. In principle this suggests that it would be reasonable for a right of appeal to exist against the decision maker where there are bona fide and reasonable grounds to believe that the code has been unfairly applied (i.e. *procedural appeals*). Such appeals rights already exist in areas like Trading Disputes.

But it must be noted that the model developed by the modification group already provides for an RMP produced by the RAB to be appealed to an entirely separate body, the Panel. The proposed available grounds for an appeal to the Panel are the same as those for any subsequent appeal to us.

Any accountability gains resulting from a second appeal, to a second appellate body, on the same grounds, in relation to the same RMP, appear likely to be nugatory. These nugatory gains would come at the cost of effectively emasculating the Panel's role in operational performance assurance matters (because its decision would never be final if the appellant did not accept it). It is not clear that this step away from self governance is merited at this time. The potential accountability gains would also entail potentially

excessive delay in determining the validity of a RMP and the uncertainty that could create.

More generally, it should be noted that the proposed opportunity to lodge an appeal with the Panel on an RMP will itself only be reached at the end of a process that has given participants multiple opportunities to provide input into, and challenge the logic of, how risks are assessed and how RMPs are set[4].

On balance, our current view is that the proposed further right of appeal of RMPs to the Authority is excessive and an unnecessary inclusion. We consider this point more broadly in the next section.

Your first question: Does the Authority think there is a role for it to be part of the appeal mechanism when considering individual Party Risk Management Plans?

No, we do not.

The concept of a Party being set targets for action that will bring it in compliance with the code is not a new one: this principle is already embodied in the existing PAF as it is discharged by the Performance Assurance Board (PAB). Under the existing baseline there is no provision for a Party to appeal a PAB decision to the Authority, and the introduction of this appeals right would therefore constitute a new role for us.

Targeting regulatory activity where it is needed

Basic principles of better regulation, including those embedded in statute[5], provide that a regulator should not take any decision that would have the effect of broadening or deepening its remit lightly.

We would therefore see our taking on a new role in this area as appropriate only if we were satisfied that it would be in accordance with our principal objective and general statutory duties, including principles of best regulatory practice. Based on the Interim Report, we are not satisfied of this.

As highlighted in our previous answers we do not consider there to be significant merit in introducing a *commercial appeals* process, because an effective proxy for this already exists in the form of the modifications process. Whilst we acknowledge some potential value in a *procedural appeals* process for RMPs, we regard this appellate role as one that could be adequately discharged by the Panel without the need for an iterative appeals process encompassing more than one appellate body.

The consumer is entitled to expect that we use our resources in an efficient manner, and we are fully committed to doing so[6]. Time spent processing potentially lengthy

[4] Section 2 of the Interim Report sets out an iterative process that would lead to the development of RMPs. Firstly, participants would be consulted on the methodology for assessing risks. This would be followed by a further consultation on the Risk Evaluation Register (RER) determined using this methodology. Once the RER was agreed, and had been used to create RMPs for each participant by the RAB, it would then be possible for the Party to formally query the content of its RMP to the RAB before a right of appeal to the Panel was invoked.
[5] The Energy Act 2004 introduced a requirement for the Authority *'to have regard to the principles under which regulatory activities should be… targeted only at cases in which action is needed'*.
[6] As highlighted in our Corporate Strategy and Plan we have adopted an RPI-3 per cent target for cost reduction for each of the five years between 2005-06 and 2009-10.

procedural appeals would not be available for other areas of our activity. It is therefore not clear that our hearing these cases would offer the consumer good value.

Your fifth question: Does the Authority believe that it is appropriate for BSC Panel Committees responsible for risk evaluation and risk assurance under P207 to be formed of members that represent their company's views, or the views of a constituency of a participant type?

An approach whereby committee members responsible for risk evaluation and risk assurance represent their company's views would appear to have obvious problems, both in the area of manageability and conflicts of interests.

There are currently 192 BSC signatories. Even restricting participation to Supplier signatories would still leave 48 signatories[7]. It would appear impractical to convene a committee with so many members were it to be one Party, one vote. At the same time, the need to ensure representation at such meetings could present resource problems for smaller Parties.

More generally, there are obvious conflicts of interest associated with the "poacher is also gamekeeper" approach. It may well be in the best interests of each Party to vote in favour of assurance priorities that it will find easiest to hit and/or which its competitors will find hardest to hit.

It should be borne in mind that the effectiveness of risk assurance plays a key role in ensuring the delivery of the code. It effectively forms a first line of enforcement activity that operates under the auspices of self governance, rather than the regulator. Increases or decreases in its operational effectiveness may therefore mitigate, or heighten, the need for regulatory intervention to ensure that the consumer interest is protected.

The group is yet to provide a detailed model of how the constituency approach would work: what the constituencies would be; would members be nominated or elected; and so on. But in principle we are more supportive of the notion of independent committee members representing constituencies than we are of company representatives. The former approach appears likely to be both more operationally manageable and with reduced risk of conflicts of interest.

P207 is only one of several fora where issues relating to the constitution of Panel Committees have recently been raised. It is open to question whether this debate is logically tied to the performance assurance framework or is a broader issue. It may be easier to understand any concerns that are held, and any implications of change, if consideration of these two issues is disentangled.

Other observations

The appeals mechanism and the nature of representation on risk evaluation and assurance committees form only two components of a much broader proposal. Therefore, whilst our statements within this letter should help to inform the Panel and the

[7] The figures in this paragraph are taken from section 3.3.1.1 of the P207 Interim Report, reflecting the numbers of signatories as at 14 November 2006.

industry in its considerations they are not intended as, nor should they be interpreted as being, indicative of a 'minded to' position (in either direction) on the overall modification.

I trust that this assists the Panel in its deliberations.

Yours sincerely

Mark Feather
Associate Director, Industry Codes & Licensing