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ENERGY BILL BRIEFING: ENERGY CODES

1. Introduction

- 1.1 The regulation of GB's electricity and gas markets is heavily dependent on a range of complex and interlocking industry codes: technical documents which lay down many of the key 'rules of the road' for the various interactions between market participants.
- 1.2 Part 5 of the Bill sets out to reform the governance of these codes. In this briefing we outline the provisions of Part 5 and explore some of their implications.

2. Background

- 2.1 Over six years ago, in its June 2016 market investigation report, the Competition and Markets Authority (**CMA**) identified that the governance arrangements for these codes were adversely affecting competition in the energy supply sector through limiting innovation and causing the energy markets to fail to keep pace with regulatory developments and other policy objectives.
- 2.2 The CMA identified two problematic features in particular: (a) parties' conflicting interests and/or limited incentives to promote and deliver policy changes; and (b) Ofgem's insufficient ability to influence the development and implementation phases of a code modification process.
- 2.3 In its report, the CMA recommended to Ofgem that it should: (a) publish a cross-cutting 'strategic direction' for code development; (b) oversee the annual development of code-specific work plans for the purpose of ensuring the delivery of that 'strategic direction'; (c) establish and administer a consultative board in order to bring stakeholders together for the purpose of discussing and addressing cross-cutting issues; (d) initiate and prioritise modification proposals that, in its view, are necessary for the delivery of the 'strategic direction'; (e) in exceptional circumstances, intervene to take substantive and procedural control of strategically important modification proposals; and (f) modify the licence conditions of code administrators to introduce the ability for the administrator to initiate and prioritise modification proposals that, in its view, are necessary for the delivery of the 'strategic direction' or to improve the efficiency of governance arrangements.
- 2.4 The CMA recommended that Government should legislate to: (a) give Ofgem the power to modify industry codes in certain exceptional circumstances; and (b) making the provision of code administration (and delivery) services activities that are licensed by Ofgem and specifying that such licence conditions will include appropriate targets to incentivise code administrators to take on an expanded role to be able to deliver pursuant to the proposed 'strategic direction'.
- 2.5 Having accepted the CMA's recommendations, Ofgem and the Department for Business Energy and Industrial Strategy engaged in two rounds of stakeholder engagement (a [2019 Consultation, Impact Assessment and Response](#) and a [2021 Consultation, Impact Assessment and Response](#)) before introducing the proposals contained in the Bill.

3. Overview of Part 5 provisions

- 3.1 Part 5 of the Bill establishes a new energy code governance regime predicated upon the designation by the Secretary of State (on Ofgem's recommendation) of particular energy codes (**designated codes**) and particular central systems (**designated systems**) which either support the operation of and/or process, transmit or store data in connection with the operation of one or more designated codes.
- 3.2 Part 5 grants Ofgem several new functions so that it can fulfil its new strategic role. These include:
 - 3.2.1 the duty to publish an annual strategic direction statement (the **SDS**) setting out its vision for how designated codes should evolve over the following year informed by Government policy amongst other things;

- 3.2.2 the ability to make direct changes to designated codes under a limited range of circumstances;
 - 3.2.3 the ability to select and license code managers who will take over responsibility for managing the code change process from the existing industry-led bodies; and
 - 3.2.4 the ability to issue directions to central system delivery bodies who are responsible for managing designated systems.
- 3.3 Alongside these new functions Ofgem is also empowered by Part 5 to carry out a planned code consolidation and modernisation exercise in order to simplify and make the codes more accessible.
- 3.4 Code managers will be appointed following consolidation and they will be required to deliver the SDS, in close consultation with industry and other interested parties via new stakeholder advisory forums. They will also be responsible for managing modifications to designated codes, including proposing, prioritising and taking decisions on changes put forward by other parties as well as raising changes of their own.
- 3.5 The Bill also grants Ofgem transitional powers to facilitate the transition to the new governance framework and ensure that the new code managers can effectively carry out their roles. This allows Ofgem to modify existing governance frameworks such as codes, licences and contracts, which will be required alongside the appointment of new code managers. They will also be able to create transfer schemes, which will ensure the passing of information and assets from the existing code administration parties to the newly appointed code managers.

4. Details and implications

- 4.1 As mentioned earlier, Part 5 establishes two new types of regulated bodies – **code managers** and central system delivery bodies otherwise known as **responsible persons** – which are to exercise functions in relation to designated codes or designated systems.
- 4.2 In order to act as a code manager, a person will first have to hold a licence authorising it to do so under the Electricity Act 1989 or Gas Act 1986. Acting as a code manager without a licence will become a criminal offence. By contrast, responsible persons will not require a licence, but will instead be specified by the Secretary of State as part of the designation of particular ‘central systems’ (IT systems which either support the operation of and/or process, transmit or store data in connection with the operation of one or more designated codes).

Selection / removal of code managers and responsible persons (clauses 135, 138 – 140)

- 4.3 Ofgem is to determine whether the selection of a person to be code manager in relation to a particular designated code is to be made on a competitive or non-competitive basis. Competitive selection is to be governed by regulations made by Ofgem (with the Secretary of State’s approval), whereas non-competitive selection is to be governed by regulations made by the Secretary of State.
- 4.4 The Secretary of State is also empowered to make regulations (a) governing the choices to be made by Ofgem between the different selection routes and (b) specifying eligibility requirements for code managers and any exclusions from eligibility.
- 4.5 Irrespective of the manner of selection, a person (**P**) may not be selected to be the code manager in relation to a designated code unless Ofgem is satisfied that P would not, if selected, have a financial or other interest likely to prejudice the discharge by P of the functions of code manager. Interestingly, the Bill contemplates that non-competitive selection may involve the selection of a code manager formed by Ofgem itself.
- 4.6 Note that Schedule 10 to the Bill makes provision for Ofgem to make arrangements concerning the pension scheme implications of appointing code managers (such as permitting incoming code managers to participate in particular schemes).
- 4.7 The Bill makes no provision as to the manner of selection of responsible persons, other than providing that the Secretary of State is to specify the identity of the relevant responsible person when designating a central system.
- 4.8 Removal of code managers is not addressed in the Bill, which perhaps reflects the approach of making the role into a licensed activity. In other words, removal of a code manager may be

intended to go hand in hand with removal or termination of its licence. Removal (or at least replacement) of responsible persons is, however, provided for in clause 135 of the Bill which allows the Secretary of State to issue a notice (on Ofgem's recommendation) changing the responsible person in relation to any designated system.

The strategic direction statement (clauses 141 – 142)

- 4.9 The SDS, which is to be published annually by Ofgem following consultation, must contain a strategic assessment of Government policies, and of developments relating to the energy sector, that Ofgem considers will or may require modifications to be made to designated codes.
- 4.10 The Bill allows for the Secretary of State to amend these arrangements so that the SDS becomes the responsibility of the new Independent Transmission System Operator and Planner, rather than Ofgem.

Ofgem's new code modification powers (clauses 143 – 144)

- 4.11 Ofgem is granted a series of sweeping new powers allowing it to modify a designated code where it considers that:
 - 4.11.1 a designated code needs to be modified as a matter of urgency, the making of the modification is likely to be delayed if done in accordance with the modification procedures otherwise prescribed, and such a delay would have adverse effects on consumers or any code participant;
 - 4.11.2 a financial or other interest of the code manager in respect of the matter to which the modification relates is likely to prejudice the making of the modification if done in accordance with the modification procedures otherwise prescribed;
 - 4.11.3 the modification is required for the purpose of implementing an SDS and the nature of the modification (for example, its complexity) is such that it needs to be made under this section rather than in accordance with the otherwise prescribed modification procedures;
 - 4.11.4 the modification is required in connection with the incorporation of the whole or part of the provision made by the designated code into another document (whether or not a designated code); or
 - 4.11.5 the modification is required in consequence of the exercise of any power conferred by Schedule 9 (transitional provisions) in relation to a different document.
- 4.12 Note that the exercise of each of these modification powers is made subject to a veto by the Secretary of State.

Directions in relation to designated systems (clauses 145 – 146)

- 4.13 Persons responsible for operating or procuring the operation of designated systems (**responsible bodies**) are to become subject to new powers of direction by Ofgem. These directions may be given for the purpose of ensuring that the responsible body (a) complies with its obligations under a designated code or (b) takes such steps as Ofgem considers may be necessary for the efficient operation or implementation of the provisions of such code.
- 4.14 In considering whether to issue such directions, Ofgem is to have regard to the ability of the responsible body (a) to recover any costs reasonably incurred by it in complying with the direction and (b) to comply with the direction without contravening its obligations under a relevant designated code or in relation to the operation of the relevant designated system.
- 4.15 It appears clear that Ofgem's directions may impose substantial costs on responsible bodies (or their contractors), e.g., by requiring the delivery of major IT projects, and to that extent there may be a question whether it is sufficient that Ofgem merely has to consider 'cost recovery' as opposed to 'return on investment' in taking such action.
- 4.16 The Bill does not make express provision for the enforcement of directions given to responsible bodies, other than to provide that they must comply with them. It may be that BEIS intends to add such directions to the category of 'relevant requirements' under the Gas and Electricity Acts, which would allow the application of Ofgem's suite of enforcement powers (including the imposition of financial penalties) in cases of breach.

Ofgem's transitional powers (Schedule 9)

- 4.17 Schedule 9 of the Bill confers extensive transitional powers on Ofgem (exercisable for a period of up to seven years) to: (a) modify particular codes specified by the Secretary of State and related licence conditions, (b) amend or terminate particular contracts (concerned with code establishment or governance or with the operation of central systems) so specified, (c) make 'run-off' schemes in relation to the consolidation of specified codes, (d) make property transfer schemes in favour of incoming code managers and (e) obtain information.
- 4.18 These sweeping powers may only be exercised for the purpose of or in connection with (a) establishing one of the new code manager roles, (b) preparing for the granting of a code manager licence to such a person, (c) facilitating the carrying out of Ofgem's transitional powers, (d) promoting efficient governance under one or more codes, or (e) harmonising the governance of particular codes or of codes in general. Note that the 'efficient governance' purpose is not available to Ofgem to justify the use of its contract amendment or termination power.
- 4.19 Schedule 9 provides that compensation is to be payable in respect of any financial loss suffered by a person in consequence of the exercise of Ofgem's powers to amend or terminate contracts or its powers to make property transfer schemes. Compensation is to be payable in each case by the relevant code manager (who will presumably be entitled to recover in turn from code participants), unless the Secretary of State directs that some other person is to be responsible for payment.

Legal accountability and the exercise of Ofgem's new powers

- 4.20 There are important issues relating to Ofgem's legal accountability for the exercise of its new powers which are not expressly canvassed in the Bill or the accompanying explanatory notes. These relate in particular to the role of the courts and the CMA in overseeing the exercise of those powers.
- 4.21 In general terms, persons aggrieved by the exercise of Ofgem's powers (or for that matter those exercised by the Secretary of State) will be able to seek judicial review of those decisions in the courts. However, judicial review is concerned essentially with correcting legal errors rather than examining the merits of decisions. And in a complex, technical area such as this one can expect the courts to play a particularly 'light touch' approach in exercising their judicial review function.
- 4.22 There are, in addition, specific appeal rights not referenced in the Bill which will naturally arise by virtue of the structure of the Bill. In particular, because code managers will be licensed, the modification of their licence conditions will give rise to specific rights of appeal to the CMA. Also, the enforcement of those conditions is subject to a bespoke review and appeal process. Something similar may apply to enforcement proceedings against responsible persons.
- 4.23 One apparently undecided matter is whether code modification decisions by Ofgem – under the transitional provisions of Schedule 9 or eventually in relation to the designated codes – are to be subject to the appeal regime under section 173 of the Energy Act 2004. This makes available a right of appeal to the CMA against a range of code modification decisions. Industry players will no doubt be keen to see at least some of Ofgem's new powers made subject to this regime.