Water market governance arrangements – a discussion document

OFWAT

About this document

The UK Government's Water Bill was introduced into Parliament and published on 27 June 2013. The Water Bill is designed to address the current and future challenges faced by the water sector, which were described in the Water White Paper.

Among other things, the Water Bill is designed to:

- increase customer choice;
- improve service provision;
- stimulate innovation; and
- drive more sustainable approaches to managing our scarce resources.

Given these proposed reforms, we need to carry out prudent preparatory work ahead of the Bill being enacted. This will enable any required changes to be captured in the arrangements that the UK, Scottish and Welsh Governments, Ofwat, the Water Industry Commission for Scotland (WICS), the water sector and customers are developing under the Open Water programme.

Alongside this document, we have also separately published a document that sets out the importance of a level playing field and discusses some of the tools we have to ensure there one exists. This governance discussion document looks in more detail at one area – the governance of market codes – as it plays a key role in helping to ensure there is a level playing field.

We welcome responses to this discussion document. They will inform our thinking as we help to implement the proposed changes.

Please note: this discussion document is not part of Ofwat's price review process, and so it does not fetter or pre-empt in any way our discretion and policy decisions relating to the 2014 price review. Details of our price review can be found in our methodology, and other documents that are clearly linked to it (such as the final determinations in due course). For the avoidance of doubt, if there is any inconsistency between this discussion document and our price review documents, for the purposes of the price review the price review documents would take precedence over this document.

Contents

Key messages

- Delivering choice for business customers, driving efficient use of precious and scarce water resources and promoting increased resilience are at the heart of the reforms the UK Government has proposed for the water sector.

- The UK Government expects the changes to deliver benefits of £2 billion to the economy over the next 30 years. These benefits will be delivered through a combination of customer choice and efficient market entry, which will:
  – create a more vibrant and open sector;
  – bring new ways of working;
  – improve customer service; and
  – help keep customers' bills down.

- A successful competitive market requires a clear understanding of the responsibilities and activities required of all parties in all elements of water and sewerage service delivery (retail, networks, treatment and resources). Clear, unambiguous rules – in the form of codes – with which all parties comply will enable the market to operate efficiently in customers' interests.

- The governance arrangements for these codes are important since they will control the way in which the market develops. The processes for raising, assessing and agreeing changes to the market rules must safeguard the interests of customers and participants alike, ensuring that developments further the interests of all parties rather than unduly favouring a discrete few.

- As the market becomes more established and competition can be seen to be effective at promoting customers' interests, the degree of regulatory oversight may be relaxed as market forces, rather than regulation, provide the necessary safeguards.

- We are working closely with the UK, Scottish and Welsh Governments, regulators and other water sector stakeholders through the Open Water programme to deliver the most appropriate market framework to increase customer choice and develop an efficient and innovative sector.

Questions for discussion

We welcome comments on any of the issues covered in this document, but in particular, we are interested in responses to the following questions.

Q1 Do you agree that existing code(s) (including from other sectors) may be a useful starting point for creating the new codes?

Q2 How do we ensure that the competing interests of different parties are balanced during the governance of codes, including creating and modifying codes?

Q3 Do you think that a governance panel is needed to consider proposed code modifications?

Q4 If so, what should be the membership of the panel?

- How should we deal with a large number of companies and keep it a manageable size?
- Do we need membership on a constituency basis? How might we include independent members from outside the water sector and customer representatives?

Q5 What should be the panel's role?

1. Introduction

1.1 Harnessing market forces

The UK Government is proposing changes to the legislative framework for the water sector in England. These changes, set out in the Water Bill, would harness market forces to enable:

- all non-household customers in England to choose their water and sewerage service supplier; and
- the trading of water upstream between incumbents and new entrants, promoting the efficient use of our scarce water resources and improvements in the resilience of services for customers.

All non-household customers in England would be able to choose who to buy their water and sewerage services from. This means that existing and new companies would have to compete with each other, seeking to find out what their customers want in terms of price and service, and striving to deliver the best deal so as to keep or win their custom. Customers would benefit from:

- improved service provision;
- efficiency savings; and
- reduced administration costs (such as by a multi-site customer being able to appoint a single supplier for all its sites).

In the upstream trading arrangements, water companies would be more easily able to buy and sell water to each other. The proposed reforms will also increase competition and encourage new entrants who can offer alternative sources of water or innovative ways of treating sewage. These changes will promote efficiency in the use of our scarce water resources and improve the resilience of services for customers.

The overall benefits to customers would be achieved through a combination of customer choice and market entry, which will:

- create a more vibrant and open water sector;
- bring new ways of working;
- improve customer service; and
- help keep the cost of customers' bills down.

1.2 What changes will be introduced?

The Water Bill proposes several changes to the water sector. In particular, it proposes to introduce a series of new authorisations to the water supply licensing framework. These authorisations would allow parties to provide services in areas that were previously monopolies or where only limited choice was available. Licensees would be able to:

- input water into the networks of the appointed water companies (referred to in the Water Bill as a **'wholesale authorisation'**) as long as that water is associated with an onward sale to customers through a retail authorisation (see below);
- take water from the networks of the appointed water companies (referred to in the Water Bill as a **'retail authorisation'**) for onward sale to their non-household customers; and
- perform equivalent services for these authorisations in the sewerage sector, and take wastewater and (or) sludge from a sewerage network for purposes of recycling or energy production, for example (referred to in the Water Bill as a **'disposal authorisation'**).

Appointed water companies would still be able to provide the services that they do today. They would also retain their monopoly to provide a retail service to household customers. They would be required to interact with – and provide services to – licensees in relation to each of the new authorisations. If an appointed water company wishes to offer wholesale, retail, or disposal services outside of its appointed area, it would need to establish a separate company, apply for a licence and be subject to the same regulations as all other licensees. In effect, it would be a 'new entrant' within these areas of the market.

1.3 How do we make sure the benefits are realised?

Experience from elsewhere in the economy shows that a level playing field must exist between all companies to avoid the risk of anti-competitive behaviours that could endanger the benefits that can be achieved through choice and market entry. Such a level playing field will provide all parties with an equal opportunity to provide services to customers.

Several tools can be used to provide a level playing field. We consider these in a separate discussion document, published alongside this one. This discussion document looks in more detail at one area – the governance of market codes – as it plays a key role in helping to ensure there is a level playing field. As we say in our level playing field discussion document, this role should adapt over time. Governance arrangements need to ensure that flexibility to adapt is balanced with the need to ensure all parties' interests are reflected in any changes. Those that are too restrictive would stifle innovation and would be likely to harm customers' interests. Similarly, governance arrangements that favour incumbents would not support a level playing field and therefore would also be likely to harm customers' interests. Within the high-level governance framework set out in the Water Bill there are some details that need to be decided. This document is intended to inform a debate about these.

1.4 Why consider this now?

In July 2012, Defra announced that a realistic target date for the retail market to open for all non-household customers was April 2017. This continues to be the target date following the publication of the Water Bill. The prudent preparatory work to design, implement and test the market arrangements has begun through the Open Water programme ('Open Water'), and we understand that a few companies have also begun to consider the changes they need to make to bring about their introduction.

We are looking at the issue of how to ensure a level playing field, including the governance arrangements for codes now, because it is part of the prudent preparation for the Water Bill being enacted. This will help meet the UK Government's target date of April 2017 for retail market opening and deliver customer benefits as soon as possible.

There are several steps in the process that need to be taken before market opening, and we are keen to hear stakeholders' views on these issues. Responses to this governance discussion document, our level playing field discussion document and other discussion documents will help us contribute to the work of Open Water.

2. Market codes

2.1 Why are codes important?

The most important consideration in designing the new markets is that customers should have access to the services they want, from the supplier of their choice. Those services could:

- be a straightforward retail supply;
- involve an alternative upstream source of water; or
- use specialised 'downstream' sewage treatment.

To be able to provide a consistent service across the country, arrangements between licensees and water companies, and between the licensees themselves, will need to be set out in a standard way. Licensees that are buying a supply of water, putting water into the network or taking out water and wastewater from the network will need to know the terms on which they can do business. Those arrangements would be defined within industry codes.

Codes are needed so that there are agreed rules around market operation. If codes are effective (and complied with) there will be less need for regulatory intervention to deal with specific issues arising, and the market can be managed by its participants. Codes can also:

- be blockers or enablers of industry change – a code that is too restrictive or too complex could stifle innovation among those in or seeking to enter the market, to the detriment of the resulting services offered to customers; and
- address some potential discrimination concerns by having rules in place – if all parties are able to compete equally, this will promote choice among suppliers to the benefit of customers and will also bring about and incentivise market entry by new participants.

Codes are an established part of all utility markets. This is because clear rules are needed to establish how those markets should operate as all participants need access to common services and facilities in order to arrange supplies to final customers efficiently. Examples of current codes include the:

- market and operational codes in the Scottish water market;
- balancing and settlement code in electricity; and
- uniform network code in gas.

Unlike non-utility markets, the ability of companies to compete with each other depends upon them having equal access to common services and facilities used to provide their services. The codes typically cover such aspects as:

- roles and responsibilities;
- levels of service;
- penalties for failures;
- market design;
- payment arrangements;
- dispute resolution; and
- monitoring.

They also typically include sets of processes for the governance of codes and how the codes themselves can be changed. Change proposals are often reviewed by an industry panel, for example. The code would set out in detail the working arrangements of the panel, including how change proposals would be submitted to it and rules on voting.
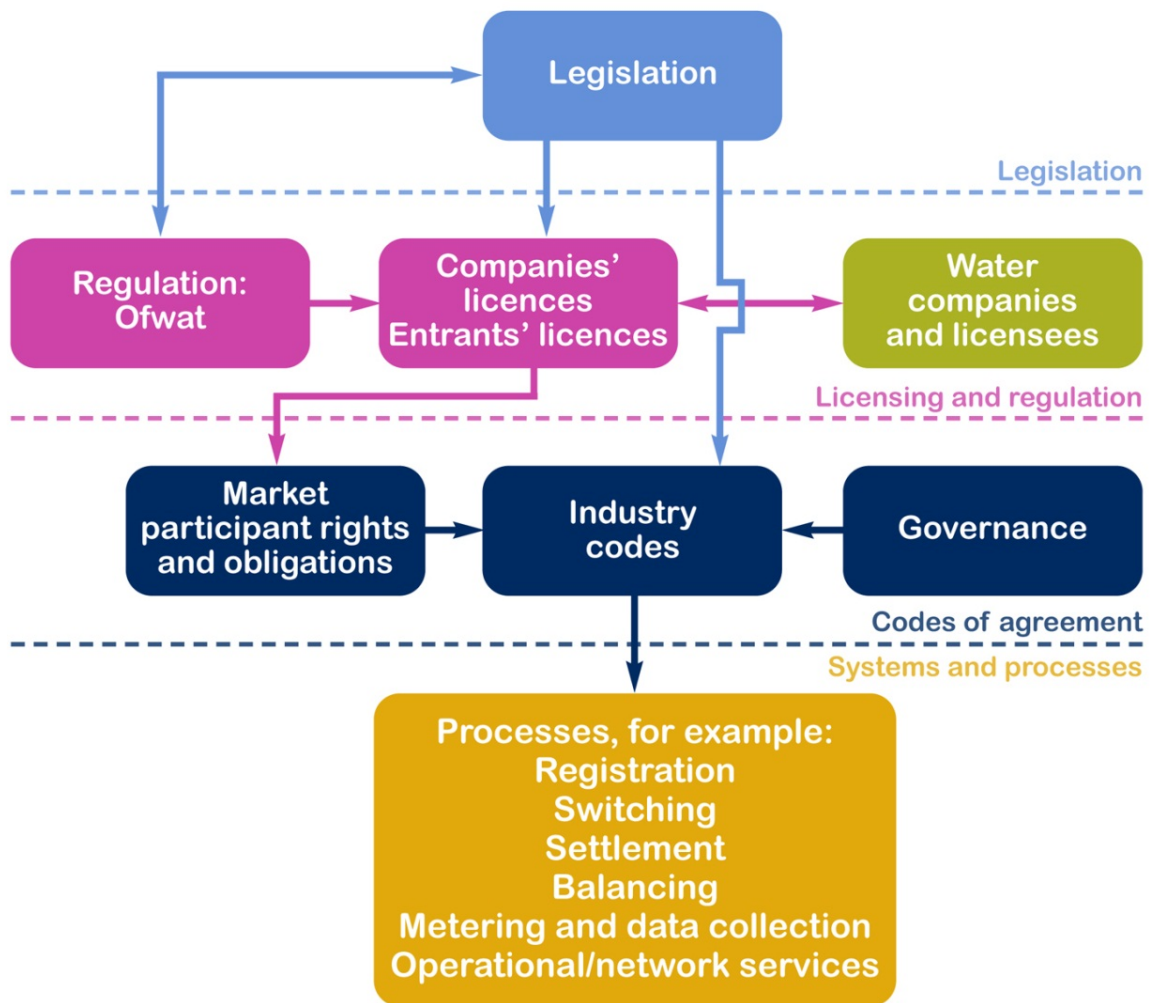
Both in Scotland and the other sectors we have considered, industry codes do not cover prices. This is because prices are either:

- subject to direct ex ante regulation, such as the price to gain access to a network; or
- negotiated between two parties – for example, the retail price charged to customers once price controls are removed.

2.2 How do codes fit within the market framework?

A key aspect of the market framework would be a set of codes that together would comprise the 'rule book' for both water companies and licensees. These would deal with how they should interact with each other on a consistent, predictable and fair basis in the new markets enabled by the UK Government's proposals. Figure 1 below shows how codes fit with the rest of the market framework.

Figure 1 Position of codes within market framework

2.3 The need for code governance and the right governance model

The Water Bill proposes for Ofwat to develop market codes in consultation with appointed water companies, licensees, other regulators, the Consumer Council for Water and any other organisations we consider appropriate.

The codes would contain the rules for how the market operates. In turn, there would need to be rules on how they can be changed over time as the market evolves. These rules are the 'governance' of the codes.

An effective governance model will help deliver the changes that are set out in the Water Bill. In particular, it will help to deliver:

- a level playing field with no undue discrimination;
- regulation that is fit for purpose and well aligned to market arrangements;
- arrangements that are flexible and capable of adapting to change; and
- new entrants who have confidence in the market.

The eventual choice of detailed governance arrangements will control the way in which the codes, and hence the market, develop and change over time.

We think that a key element of the governance model is the process to be followed for raising, assessing and agreeing changes to the codes. That process must safeguard the interests of customers and participants alike, making sure that (as far as possible) any changes are in the interests of all parties in the market rather than just a distinct few.

Governance arrangements need to strike an appropriate balance between self (industry) determination and sufficient regulatory oversight to ensure customers are protected and that parties are not unduly discriminated against.

Given the large number of appointed companies, and the significant degree of vertical integration, establishing the right balance will be critical to the successful development of an efficient market if delays and extensive numbers of appeals are to be avoided. An appropriate balance will also be needed to make sure that parties with competing interests in the market have sufficient representation in the processes to create and modify codes. Without that balance, the requirements in codes could be one-sided and stifle activity in the market.

Another important consideration is that the governance model should harness the expertise of companies in the market and take account of customers' views. A code that the water sector and customers have helped to shape is much more likely to meet the operational requirements necessary to enable efficient customer switching than one that has been created by the regulator in isolation.

Our examination of these issues has reaffirmed our view that the details of code governance should not be static. The developing structure of codes, changing membership and the impact of external factors all reinforce the requirement for flexible, responsive governance arrangements with a degree of regulatory oversight and possibly intervention to protect the interests of consumers and water sector participants.

In recognition of the changing nature of governance, in the next chapter we summarise the governance proposals in the Water Bill in the context of the broader range of governance models. Depending on how competition in the market develops, it may become appropriate to evolve the governance arrangements in the future. We discuss the spectrum of governance arrangements because we would like stakeholders to understand the context of the proposals in the Water Bill, and to think beyond 'day one' of the market and consider how governance might change over time.

3. Code governance

In this chapter we explain the proposals in the Water Bill, as well as some of the arrangements that exist in other sectors to provide context.

Although the Government has established the broad governance framework in legislation, there are still some more detailed operational issues that need to be decided. In the next chapter, we look at how the proposed governance framework might be broadly implemented, and set out the issues for consideration.

3.1 Introduction

Across the economy there are several possible models for code governance with varying degrees of control for the regulator and industry. These range from industry self-regulation (with no regulator involvement) through to complete control by the regulator (with no involvement from industry). The governance approach and the responsibilities of the industry and the regulator vary across this spectrum. In the middle, there are different degrees of input and control for the regulator and industry.

The choice of governance model will influence directly the process of code development. So, it is an important tool in ensuring that there is a level playing field. We consider that there are three key elements (or stages) in the process of code development. These are:

- the initial creation of the code(s);
- governance of ongoing modifications that may be necessary as the market develops; and
- governance over the compliance and enforcement of code rules.

The roles and responsibilities of the industry and the regulator will vary across these three areas, depending on where the governance model is on the spectrum. At the two ends of the spectrum, the regulator or industry will have complete control over all three areas.

We summarise two examples of code governance from other sectors below. The first is an example of industry self-regulation from the financial services sector; the second is an example of overall regulatory control of codes from the energy sector. It should be noted that these examples have been chosen to illustrate two different points on the spectrum of possible governance arrangements in order to facilitate discussion about these issues, and are not the only models for code governance.

We also summarise the code governance for the retail water market in Scotland, which is another useful example in the context of this discussion.

3.2 Examples of different types of code governance

Example 1: Industry self-regulation

An example of industry self-regulation is the Banking Code, introduced in 1991 (and superseded in 2009). This code was the set of good practice standards that UK financial institutions could choose to sign up to when dealing with personal customers. It covered current accounts, savings, cards and loans.

An independent organisation, the Banking Code Standards Board (BCSB) administered and enforced the code and there were independent code reviews every three years. Industry associations owned the code and were responsible for preparing amendments to it. Neither the independent reviewer nor the regulator, the Financial Services Authority (FSA), could amend the code without industry agreement.

Some aspects of the Banking Code became directly regulated by the FSA from 2009. This was partly because of changes in EU legislation and partly because of an increase in signs of market failure indicated by:

- customers choosing less appropriate services;
- poor after-purchase service; and
- an increase in the number of complaints to both the firms and the Financial Ombudsman Service.

Example 2: Regulator signs off major changes

The Balancing and Settlement Code (BSC) created as a result of the New Electricity Trading Arrangements (NETA) in the GB electricity market is an example of governance arrangements where the regulator has more control, but there is also an important role for industry.

The BSC covers the arrangements for system balancing and settlement between parties in the electricity market, and is administered by Elexon, which is the market administrator for the code. It was created as a result of NETA and developed by the regulator and the industry during NETA's implementation. The obligation to provide a code, comply with it and facilitate change rests within licence conditions. The contents of the code include:

- party and meter registration;
- settlement;
- market entry and exit rules;
- metering requirements (including codes of practice); and
- compliance.

Parties to the code may raise amendments and the BSC panel reviews these. The panel makes recommendations to Ofgem on substantive changes to the code. Ofgem approves changes and issues directions to implement approved changes. In certain circumstances, the code allows Ofgem's decisions to be referred to the Competition Commission (or the Competition and Markets Authority in the future – it is important to note that the Department for Business, Innovation & Skills (BIS) is currently consulting on the appeals process).

Ofgem requires compliance with the code through licence conditions applying to all licensed electricity companies engaged in the relevant market. It also:

- signs off code amendments; and
- enforces material or systemic breaches of the BSC through the licence requirement to comply with the code.

Example 3: Code governance arrangements in the retail water market in Scotland

The market for non-household customers in Scotland was established by the Water Services etc. (Scotland) Act 2005. WICS is responsible for implementing the market framework. The two main codes are the market code and the operational code.

The market code governs the relationship between the Central Market Authority (CMA) and the other parties in the market. It also sets out the duties of the CMA. The CMA administers the market, operating the computer systems that run it and keeps a record of supplier activities in the market, including recording which suppliers are responsible for the services at each connection point. Every month the CMA uses this information to work out the wholesale charges that suppliers must pay to Scottish Water.

The operational code governs the relationship between Scottish Water (as the provider of wholesale services) and the licensed providers.

Scottish Water is required to comply with both codes under the terms of a Direction issued by WICS. Licensees are required to comply with the codes under the terms of their licences. WICS is the body responsible for enforcing compliance.

Requests for changes to the codes are handled by the Technical Panel (TP). Parties that are active in the market make up the membership of the panel. Change proposals are subject to a vote. If a proposal is approved by the panel, WICS will consult publicly on it. WICS also has the power to block change proposals if it considers that they are not consistent with the codes' objectives and principles, and can require changes to be made to the codes outside of the TP process.

As well as the operational and market codes, there is also a governance code which sets out the rules to ensure there is adequate separation between Scottish Water and its subsidiary (and retail licensee) Business Stream.

3.3 Appropriate code governance model

The proposals in the Water Bill recognise that an industry-controlled model would not be appropriate for a market in the early stages of developing a level playing field. The risk of unduly preferential or discriminatory behaviour would be too high because regional monopolies will still be the dominant providers at market opening and will also be operating in (and controlling) both the 'upstream' and 'downstream' parts of the market.

New entrant providers could find it difficult to gain a foothold, leading to much less competitive pressure on incumbent providers. The lack of pressure could become apparent in a lack of responsiveness to customers' views and needs. It would also be very difficult to make sure that it operated transparently with a free flow of reliable information to all the market participants who required it.

There is also a risk that a framework where the regulator has a very high degree of control could result in an excessive regulatory burden on market participants that would stifle activity and dissuade new entrants. In addition, it is unlikely to result in the most effective codes or market development, without industry involvement. It introduces higher risks of regulatory failure when the experience of existing participants (such as those already participating in the Scottish market) cannot be brought to bear in shaping the proposals for detailed arrangements.

3.3.1 Learning from the Scottish experience

The Scottish market opened on 1 April 2008. Since then, most customers have moved off the original default tariffs and on to a more tailored service. As part of our work with stakeholders to develop the market in England, we will be considering whether any aspects of the Scottish market experience can be transferred to England. There are likely to be substantial opportunities to learn from the Scottish experience and either avoid mistakes or reduce the time taken to develop effective codes. But there are some key differences between the market in Scotland and the one proposed for England that we will need to bear in mind.

- In Scotland, there is one wholesale provider of water and sewerage services. In England, there will be different regional providers, including those that only supply water.

- The market in England will include 'upstream' competition. These arrangements will need to link to the retail market to enable benefits to be realised for customers.

- Scottish Water is part of the public sector, whereas companies in England are privately owned.

- The legislative framework in England is different from that in Scotland.

These factors may limit the scope for simply duplicating the existing Scottish arrangements, but the Scottish code governance arrangements provide a useful starting point for our considerations about implementing the proposals set out in the Water Bill. We summarise these below.

3.4 The governance framework in the Water Bill

The Water Bill proposes code governance arrangements that balance the responsibilities of Ofwat and the water sector, in order to ensure sufficient regulatory oversight, but recognising the importance of sector involvement in this process.

For each of the three main areas of code governance, we summarise below the proposals set out in the Water Bill.

3.4.1 Initial code creation

The Water Bill provides that Ofwat would be responsible for issuing initial codes, after consultation with the water sector and other relevant stakeholders. In relation to the first edition of each code, it also provides a right for ministers to direct Ofwat not to issue the code or amend it as directed.

We expect Open Water to develop the proposed content of the initial codes, which we will then consult on. But when issuing the initial codes, it is important to note that we will be required to have regard to our statutory duties. We will also have regard to any relevant code objectives that we may put in place.

3.4.2 Code modifications

Ofwat will be able to revise codes, subject to consultation with the water sector and other relevant stakeholders.

As an exception, Ofwat would be able to make minor or urgent revisions without consultation, although any urgent revisions to codes made without consultation would fall away after a short period. The explanatory notes to the Water Bill indicate that the intention is that we would use this time to consult on making the revisions permanent or to consider replacing them with alternative revisions that provide a permanent solution to the issues that it was seeking to rectify.

The Water Bill proposes to allow the Secretary of State to provide for appeals to the Competition and Markets Authority against Ofwat's decisions to revise a designated code, or not to make a revision following consultation about a proposed revision.

3.4.3 Enforcement of codes

We would have the power to direct compliance with codes and such directions would be enforceable under section 18 of the Water Industry Act 1991.

3.5 Summary

The proposals for code governance that are set out in the Water Bill provide for water sector involvement with an appropriate degree of regulatory oversight and reflect the early stage of market development. Such balance is important. Although we (and in the initial stage, ministers) will have the ability to ensure a level playing field and protect customers, the sector will need to help develop and maintain the codes in order for them to be fit for purpose.

The Government has decided on the broad governance framework for codes, as set out above, and we support that overall governance framework. But the implementation details within this framework still need to be decided. This includes:

- how codes are created;
- how they are modified; and
- what the different processes for making major or minor modifications are.

In the next chapter, we consider how the proposed governance framework might be broadly implemented, and set out some of the issues we would like comments on. The Water Bill is, of course, subject to parliamentary change, and we will adapt our proposals in light of any changes that may be made as the Bill goes through the parliamentary process.

4. Discussion

As explained above, although the Government has decided the overall framework for the governance of codes (as set out in the Water Bill), the details about implementation within that framework still remain to be decided.

To promote the best outcome for customers, we have developed five high-level criteria (subject to relevant legal duties) in conjunction with Defra's High Level Group (HLG) and Open Water. These criteria are intended to inform decisions about market design and delivery. Options to implement the broad governance framework and proposed code content will be assessed against these five criteria.

1. Ensures the efficient discharge by licensees of the obligations imposed upon them by their licence.

2. Promotes the efficient, economic and co-ordinated operation of the water and sewerage sector.

This includes:

- ensuring that the retail market arrangements do not disincentivise the promotion of efficiency across the less contestable parts of the value chain; and
- ensuring arrangements are adaptable to changing circumstances, including the development of upstream markets, the potential extension of the market to Wales and any decisions relating to the Scottish market.

3. Promotes effective competition in the sector's contestable markets, wherever appropriate.

This includes:

- minimising barriers to entry and exit for market participants (both in terms of information asymmetries and financial and non-financial costs, such as entry requirements and processes);
- ensuring new entrants and incumbents are treated equally and not (dis)advantaged by market design and (or) their position or dominance in the wider value chain (for example, an incumbent company's continued role as supplier to household customers and as the wholesaler and network provider);

- minimising the transaction costs of operating within the market, which could give rise to barriers to entry; and
- encouraging and enabling efficiencies and innovation in services.

4. Promotes customer participation in the market.

This includes:

- ensuring customers can easily identify and compare retailers' service offerings and elect to switch if they wish;
- minimising barriers to customers switching retailer;
- promoting customer confidence in the market, including through appropriate privacy and security of customer data; and
- avoiding unnecessary barriers to interaction with the Scottish retail market.

5. Promotes efficiency in the implementation and administration of market facilitation activities.

This includes:

- maximising transparency and efficiency in the delivery of new facilitation arrangements, including introducing competition into the delivery of these activities wherever appropriate.

There are two areas in particular where we are interested in seeking initial views. These cover the governance of market codes, including the initial phase of code creation and the subsequent process of making changes to the codes once they are in place. The broad questions we are seeking views on are as follows.

- **How should Ofwat and Open Water go about creating codes?**
- **How should the governance process of code modifications be effectively managed, once the initial codes have been created?**

In the rest of this chapter, we discuss each of these in more detail.

4.1 How should Ofwat and Open Water go about creating codes?

As explained above, we expect Open Water to develop the proposed content of the initial codes, which we will then consult on (as proposed in the Water Bill) and implement. But, when issuing the initial codes, it is important to note that we will be required to have regard to our statutory duties. We will also have regard to any relevant code objectives that we may put in place.

Before the detailed code content is developed by Open Water, there are two main issues to consider in relation to the process of creating codes.

- Do we start from scratch, or consider existing examples of similar codes and build on another code that already exists?
- How do we ensure that we create a code that appropriately balances competing interests of market participants and customers?

We will discuss each of these in turn below.

4.1.1 Build from scratch versus base on an existing code

There are two main options for developing the codes: either start with a blank sheet of paper and develop new codes as required, or use existing codes as a starting point and look for potential areas that need revision.

There are advantages and disadvantages for each in terms of time, cost and quality.

Starting from a blank sheet of paper is likely to be more resource intensive for both Open Water and the water sector. It is also likely that developing codes in this way would take longer. But, the bespoke nature of the codes may result in codes that provide a higher level of assurance for Ofwat and greater market effectiveness.

On the other hand, considering existing code(s) and revising as necessary is likely to be quicker, and use relatively fewer resources. But, this option assumes that there are existing codes that are suitable for adapting and may not result in the same level of assurance or market effectiveness.

As there already codes in place in other sectors (for example, energy) and in the water retail market in Scotland, we think that the second option (taking existing code(s) as a starting point and revising as necessary) may be the best way forward, but we are interested in stakeholders' views on this.

> **Q1** Do you agree that existing code(s) (including from other sectors) may be a useful starting point for creating the new codes?

4.1.2 Balancing the interests of market participants and customers

Earlier in this discussion document, we outlined the work of Open Water to help implement the changes. We are committed to using Open Water to engage with the water sector to develop the codes.

To ensure that this process results in codes that are effective and fit for purpose, we are considering how best to ensure the competing interests of market participants and customers are balanced when developing the codes. As explained earlier, the codes will be a vital tool to help ensure a level playing field. So it is important that we ensure the governance of codes, including their initial development and ongoing modification, is carried out in a way that balances the interests of all market participants or potential market participants, and the interests of customers.

> **Q2** How do we ensure that the competing interests of different parties are balanced during the governance of codes, including creating and modifying codes?

4.2 Managing the process of code modifications

It is equally important to ensure competing interests are balanced during the process of making ongoing changes to codes, to ensure that any changes to them do not unduly disadvantage certain market participants, or deter new entrants, or adversely affect customers. So the process of managing code modifications needs to effectively manage these different interests.

In addition, it is unrealistic to expect us to be able to consider all modification requests in detail, as the process of making changes to the codes needs to support numerous, detailed and sometimes urgent changes.

In some other sectors, panels play an important function in code governance arrangements. For example, a panel is used to help manage the Uniform Network Code (gas). Another example is the water retail market in Scotland, as described in section 3.2.

A third example is the Balancing and Settlement Code (BSC), which makes recommendations to Ofgem. It has the following membership and functions.

Balancing and Settlement Code (BSC) Panel

The BSC places an obligation on the BSC Panel to ensure that the provisions of the BSC are given effect fully, promptly, fairly, economically, efficiently, transparently and in such a manner as will promote effective competition in the generation, supply, sale and purchase of electricity.

BSC Panel functions include:

- ensuring that the BSC is given effect, according to its terms, and ensuring that BSC parties comply with the BSC provisions;
- establishing panel committees of industry experts to carry out functions on its behalf, including establishing arrangements for resolving trading disputes arising under the BSC;
- deciding on the suspension of specific rights of any defaulting BSC party according to section H of the BSC;
- overseeing changes to the BSC through the modification process, and recommending to the Authority on whether modification proposals should be approved;
- adopting new and revised Code Subsidiary Documents (CSDs);
- determining values for trading parameters to be applied in the BSC, and recommending to the Authority in respect of others; and
- acting as an appeal body in some instances – for example, trading dispute referrals.

The BSC Panel must assess modification proposals against a defined set of criteria laid out in the transmission company's licence. The panel makes determinations on trading parameters and has powers to ensure BSC parties are complying with the BSC rules.

The panel has 11 members, including the Chairman. Membership includes representatives from a consumer organisation and an independent member, as well as industry representatives. Trading parties elect industry panel members for two-year terms. Panel members must act impartially and not be representative of any one party or class of parties.

In order to effectively manage the process of agreeing code modifications with the water sector and other stakeholders, it may be useful for us to establish some sort of panel to consider proposed code modifications. This would help to ensure appropriate sector input into the process and would also help to avoid delays that might otherwise occur if we had to consider every proposed change in detail.

A panel of members drawn from market participants and other relevant stakeholders is likely to be better placed than Ofwat to consider some of the detailed process issues. But with so many companies represented in the water sector, there may be a need to reduce the membership of the panel to ensure that the arrangements are workable. In other sectors, panel members are appointed on a 'constituency' basis – for example, a single member may represent a variety of similar interests. Such constituencies could be split by size, region or function or on some other basis. So, we could have members drawn from a subset of companies based on size or it could

be split between water only company members and water and sewerage company members. Below we set out the example of a panel drawn from constituent members, the Code Board for the Smart Metering Installation Code of Practice.

The DECC Smart Metering Installation Code of Practice – Code Board

The Smart Metering Installation Code of Practice (SMICP) specifies the minimum standards for members to follow in relation to the customer-facing aspects of the installation of smart metering systems. The main aim of the code is to make the customer experience of the installation process positive and to protect customers during the process.

The Code Board is the decision-making body for changes to the SMICP, although Ofgem retains overall approval. Among other things, the SMICP Code Board is responsible for:

- the efficient operation and governance of processes within the code;
- approving change requests for submission to Ofgem;
- managing the reporting and monitoring process;
- providing overall assurance of the robustness of the code; and
- considering issues for resolution.

The Code Board consists of representatives from the following constituents.

- Large suppliers – six representatives.
- Small domestic suppliers – two representatives.
- Micro business suppliers – two representatives.
- The National Consumer Council – two representatives.

A licensee can only sit within one constituency. It is for the constituents to agree their representatives on the Code Board, including any changes. The Code Board membership will be reviewed periodically. The code administrator will run a voting process for constituent representatives if they cannot be otherwise agreed. The following parties are also invited to send a representative to the Code Board as observers.

- Ofgem.
- Department for Energy and Climate Change (DECC).
- Network operators.
- Meter operators.

A panel would then be able to consider possible modifications and make recommendations to Ofwat. As the Water Bill proposes that Ofwat will retain the power to formally make changes to the codes, we expect that any panel would be advisory, rather than decision making. But we consider that there are clearly benefits from having a panel working to agreed objectives to recommend proposed modifications to the codes. The Water Bill also provides that market participants will be able to appeal code modifications (to the Competition and Markets Authority) where we do not take forward recommendations on code modifications. It is also possible that such a panel could have a decision-making role in relation to certain

subsidiary documents. Over time, we may be able to move to a self-regulatory model without Ofwat involvement.

We would welcome stakeholders' views on:

- whether such a panel is needed;
- the possible membership of such panels on particular codes (for example, market participants, wider industry stakeholders and customer representatives); and
- the role of such a panel.

Q3 Do you think that a governance panel is needed to consider proposed code modifications?

Q4 If so, what should be the membership of the panel?

- How should we deal with a large number of companies and keep it a manageable size?
- Do we need membership on a constituency basis? How might we include independent members from outside the water sector and customer representatives?

Q5 What should be the panel's role?

4.3 Distinguishing between major and minor changes

The Water Bill distinguishes between minor or urgent revisions, with the latter being decisions where we do not consider consultation is necessary or where a revision is desirable to make without delay. To help ensure that the process of agreeing code modifications runs smoothly and efficiently, it would be useful to distinguish between major and minor changes to the codes. It will be necessary to establish different processes for agreeing changes, depending on whether the proposed modifications are major or minor changes.

Some established codes already distinguish between different sorts of modifications. For example, the Distribution Connection and Use of System Agreement (DCUSA) from the energy sector includes criteria for deciding whether a matter is either a 'part 1 matter' or a 'part 2 matter', as the governance arrangements vary accordingly. These criteria are set out below.

Distribution Connection and Use of System Agreement (DCUSA) criteria

If an issue satisfies one or more of the following criteria (or concerns various specified provisions of the DCUSA), then it is regarded as a part 1 matter.

- It is likely to have a significant impact on the interests of electricity consumers.
- It is likely to have a significant impact on competition in one or more of:
    - the generation of electricity;
    - the distribution of electricity;
    - the supply of electricity; and
    - any commercial activities connected with the generation, distribution or supply of electricity.
- It is likely to discriminate in its effects between one party (or class of parties) and another party (or class of parties).
- It is directly related to the safety or security of the distribution network.
- It concerns the governance or the change control arrangements.
- It has been raised by the Authority or a DNO/IDNO party pursuant to clause 10.2.5, and/or the Authority has made one or more directions in relation to it in accordance with clause 11.9A.

These issues will need to be considered as part of the initial code development by Open Water.

4.4 How codes may develop and change over time

We expect that code governance arrangements will change and evolve over time as the market develops and competitive pressures from new entrants help to ensure balance between competing interests and a greater focus on customer requirements.

Although it is appropriate for the regulator to play a central role during the initial development of a market, when the incumbent water companies are supplying 100% of customers, we anticipate that in the longer term we will be able to gradually step back to allow greater self-regulation by the water sector.

So although the proposals for code governance in the Water Bill imply that Ofwat needs to be quite heavily involved, we expect that this may change over time, either through the flexibility that the legislation already allows or through further legislative change in the future.

Ofgem's review in 2007-10 of the governance arrangements in place at that time is an example of how code governance may need to adapt over time. That review resulted in both further refinements to the code governance arrangements (in some instances increasing regulatory oversight), and some deregulation of certain aspects of code governance.

Ofgem code governance review[1]

The purpose of the first Ofgem review was to consider whether code structures presented an undue barrier to entry for small players because of their complexity. Ofgem's considerations included:

- how the evidence base for proposed code changes could be improved;
- whether the fragmented nature of the codes hampered cross-code issues;
- whether there was scope for increased self-regulation; and
- whether the committee structures were representative of the market.

Ofgem also set out aspirations for code governance, which:

- were inclusive, accessible and effective consultation;
- were governed by transparent and easily understood rules and processes;
- were administered in an independent and objective fashion;
- demonstrated rigorous and high-quality analysis;
- were cost effective;
- were sufficiently flexible to circumstances; and
- delivered a proportionate regulatory burden.

Outcomes of the review included the following.

- An industry-developed code administration code of practice and a licence condition to have regard to its principles.
- Code administrators adopted a 'critical friend' approach, providing support for code amendment cases and code operation (especially for small players and consumer representatives).
- Code panels were required to set out reasons for their decisions.
- Ofgem was given powers to send modification proposals back for reworking (for example, if they were judged to have insufficient analysis).
- Independent chairs and voting consumer representatives were included on the all code panels.
- Ofgem was given the right to lead significant code reviews where complex changes are needed.
- Code self-governance was introduced for areas where there is minimal consumer impact and for the more operational code changes.

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[1] Sources:
http://www.ofgem.gov.uk/LICENSING/INDCODES/CGR/Documents1/Open%20letter%20announcing%20governance%20review.pdf
http://www.ofgem.gov.uk/LICENSING/INDCODES/CGR/Documents1/CGR_Finalproposals_310310.pdf

5. Next steps

This discussion document is intended to stimulate discussion and we welcome your views on the issues set out in it.

If you wish to respond to the issues raised in this document, please send your response to LPFinbox@ofwat.gsi.gov.uk. Responses to this discussion document will help us to move this work forward.

We expect there will be ongoing dialogue about the issues contained in this discussion document, and further consultation in due course.

5.1 Future engagement

This is one of a series of both Ofwat and sector-led discussions that will be conducted over the next few years. We have published our level playing field discussion document alongside this document, which is about the development of a level playing field for all market participants and is intended to be read together with this document.

In addition to Open Water work streams, we will manage a regulatory work stream to develop the set of licences that will be needed to implement these reforms. That work will link closely with the issues discussed in this document because governance provisions may be included within licences. This work will run in parallel to the Open Water programme.

Although Government ministers and Ofwat would hold certain powers under the Water Bill, we expect that the market framework will be developed closely with the water sector. We look forward to a constructive and open debate about these issues.

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