



The Joint Office, Transporters,
Shippers and other interested parties

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19 May 2005

Dear Colleague,

Uniform Network Code modification proposal 002: 'Use of Principles of Governance in applying Section Y of Network Code' (formerly Transco Network Code modification proposal 714).

Ofgem¹ has carefully considered the issues arising from modification proposal 002 'Use of Principles of Governance in applying Section Y of Network Code' and has decided not to direct the implementation of this modification, as we do not believe that it will better facilitate the achievement of the relevant objectives of the Uniform Network Code (UNC). In this letter we explain the background to the modification proposal and outline the reasons for making our decision.

Background to the proposal

Gas Transporters (GTs) are obligated under the conditions of their licence to establish transportation arrangements consistent with their duties under section 9 of the Gas Act 1986. The document specifying such transportation arrangements is referred to as the network code. The GT licence also obliges GTs to prepare a document outlining the modification procedures for the network code.

Until recently the modification rules for Transco's network code were a separate document and therefore not subject to the governance arrangements they provided. The implementation of modification 0679 brought about the inclusion of the modification rules in network code (section Y). As such, any signatory to the network code can propose an amendment to the modification rules.

Since the implementation of modification 0679, a number of modification proposals have been raised in relation to modification rules, seeking to improve governance arrangements for

¹ Ofgem is the office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

network code changes. These proposals are largely the result of work undertaken by the Gas Forum working group.

In June 2003 Ofgem published the document 'Gas Retail Governance – Further Consultation', which consulted upon the introduction of a new document, the Supply Point Administration Agreement (SPAA). This document itself followed on from Ofgem's July 2001 consultation on the change of supplier process and associated governance arrangements. This document identified, amongst other things, the need for new governance arrangements to cover the inter-supplier procedures that are fundamental to an effective customer transfer process.

The SPAA itself was developed largely by gas suppliers under the auspices of the Gas Industry Governance Group, facilitated by the Gas Forum. In order to provide a framework for its assessment of the SPAA, Ofgem highlighted 6 themes which it considered to be principles of good governance. These were as follows:

1. Effectiveness – arrangements must be capable of achieving what they set out to do;
2. Efficiency – arrangements must be cost efficient and balance the need to produce timely resolution with thorough consideration of issues;
3. Transparency – operation and decisions must be transparent to all and appropriate information must be made available to all interested parties;
4. Participation – there must be no exclusion of relevant information or viewpoints and all appropriate contributions must be allowed;
5. Accountability – governing bodies must be accountable to stakeholders for their decisions; and
6. Consistency – arrangements must recognise the boundaries of their remit and their relationship with other governance tools.

Transition from Transco's Network Code to the UNC

This modification proposal was originally raised in respect of Transco's network code, and followed the modification rules pertaining to that code. Following the implementation of modification proposal 745², and in accordance with the Part IV, paragraph 2.1 of the UNC Transitional Rules, this modification proposal is deemed to be made in respect of the UNC.

At its meeting of 3 May 2005, the UNC modification panel agreed to the re-numbering of live modifications carried over into the UNC under the transitional rules. At that meeting modification proposal 714 was re-numbered as UNC modification proposal 002. The UNC modification panel also voted for this modification proposal to proceed without re-consultation.

Ofgem has therefore considered this modification proposal against the relevant objectives of the UNC, as set out in standard special condition A11 of relevant GT licences.

The proposal

This proposal seeks to ensure that changes to the network code modification regime are aligned with what is considered to be best practice, by adopting a set of network code principles of governance, initially based upon those previously published by Ofgem. It is intended that these

² See www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/11299_745_letter.pdf

principles would serve to guide network code parties who wished to propose changes to section Y, and ensure that the modification panel makes reference to best practice when considering such modification proposals.

The proposer considers that the modification proposal will make the operation of the modification process more transparent and hence remove any suggestion of discriminatory or preferential treatment by Transco.

Respondents' views

Transco received twelve representations in response to its consultation on this modification proposal, eleven of which supported implementation, with the twelfth offering comments but no specific view. Two respondents noted that the existing processes have on the whole delivered a workable methodology and that Transco's stewardship of the process to date has been largely satisfactory. The proponent felt that although the principles of good governance are generally followed in the management of the network code modification processes, this would be reinforced by their inclusion within a codified document. Respondents generally felt that this modification would, if implemented, increase the transparency of the process, providing particular clarity on how modification proposals to section Y should be handled. Four respondents stated that the proposal would not make the governance process overly complex.

There were several comments on the intended status of the document containing the principles. Six respondents stated that the document should not be an Ancillary Agreement, which is a defined term under Section V 1.3.1 of the network code, but simply a referenced document. Three respondents stated that the modification panel should be responsible for maintaining the document. This would be analogous with the chairmen's guidelines, reference to which was recently introduced into network code by modification 709.

Transco's view

Although Transco expressed support for the intent of the modification proposal, it did not recommend its implementation and therefore did not provide supporting legal text with the Final Modification Report (FMR). Transco recognises that the intent of this proposal is to provide further clarity as to the appropriate criteria against which to consider changes to section Y of the network code. However, Transco points out that each modification proposal must be considered on its own merits, with regard to better facilitating the network code relevant objectives, and that the addition of further criteria and principles will add complexity and potential conflict within the process, and therefore not better facilitate achievement of the relevant objectives. Transco is also concerned that the addition of any further, different criteria could detract from the relevant objectives, as set out in its licence.

Transco notes that that the panel may require assistance in evaluating modification proposals to amend section Y of the network code, and therefore suggests that the principles of good governance could be incorporated into the terms of reference for the panel. Transco considers that this could provide some guidance as to how best to assess governance proposals, whilst ensuring that consideration of the network code relevant objectives continues takes precedence.

Transco also questions the means by which compliance with these principles will be enforced if they do not form part of the network code itself. Transco also considers that it is unclear how

changes to the principles document might be proposed and approved. It goes on to state that maintenance by the panel only, without equal opportunity provided to other network code users or Ofgem, would not be transparent or equitable.

Ofgem's view

Ofgem supports the principles of good governance and welcomes proposals that, with regard to those principles, can demonstrably improve the governance of the network code modification procedures. Ofgem is therefore sympathetic to the intent of this proposal. However, Ofgem's decision must be based upon whether the proposal to formally include references to such principles within the body of the UNC will further the relevant objectives of the UNC.

Although neither the proposal itself, nor the proponents subsequent response specified how the proposal would better facilitate the relevant objectives, this was commented on by two respondents who stated that the proposal would further the relevant objective of the efficient discharge of Transco's obligations under its GT licence.

As quoted in the FMR, when it accepted modification 0679 Ofgem stated its view that the relevant objectives, as defined at that time in standard condition 9 of the GT licence, in particular objective b) regarding the efficient discharge of Transco's obligations under that licence, are adequate for judging the benefits of a proposal to modify section Y of the network code. Ofgem considers that this is further reinforced through standard special condition A11, which introduced a new relevant objective regarding the promotion of efficiency in the implementation and administration of the network code and/or the UNC, which may be more directly applicable to governance matters.

Ofgem also considers that good governance of the UNC can of itself facilitate effective competition between shippers and suppliers. It is important that market participants have confidence both in the robustness and stability of the transportation arrangements reflected in the UNC, and in the ability for those arrangements to be modified as appropriate, where circumstances warrant it. Ofgem notes the views expressed by several respondents that the modification procedures have worked well to date, though this should not preclude problems being addressed or other improvements being made where possible.

In its letter accepting modification 0679, Ofgem stated that it would be helpful if any party proposing a change to the modification rules could give consideration to the principles of good governance, in addition to the relevant objectives themselves. Ofgem remains of the view that this would be helpful, particularly as some proposals involve a degree of trade-off between the various principles. For instance, an additional rule could increase transparency and accountability, but could reduce the degree of flexibility within the process or otherwise reduce the prevailing level of efficiency. It would therefore increase the likelihood of the proposal being accepted if it could be clarified that these trade-offs have been considered and that on balance the effect of the proposal is a net improvement to the governance of the UNC.

Ofgem notes the intent of the proposal that the panel may refer a governance proposal back to the proposer together with suggested areas for amendment so that the proposal may better facilitate the principles of governance. Whilst Ofgem supports the modification panel playing a greater role in the modification process, this suggestion would raise some issues. Firstly, whilst reference to the principles might be beneficial in terms of providing greater clarity, omitting such

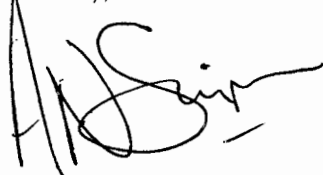
reference would not in itself invalidate the proposal and therefore should not be grounds for it not to proceed. Secondly, this would involve the panel in a function normally carried out by development workstreams, whereby proposals that are not considered to be sufficiently well drafted are referred to the relevant workstream for further development. In this regard, Ofgem notes that subsequent to this proposal being raised, at the September 2004 modification panel members voted to establish a new workstream to consider changes to section Y of the network code, to be called the Governance Workstream.

Ofgem considers that better governance, by way of new principles, could be achieved without necessarily codifying these. For instance, Ofgem notes Transco's suggestion that the principles of good governance could be incorporated into the terms of reference of the modification panel. They could equally be incorporated into the terms of reference of the Governance Workstream. Whilst Ofgem notes Transco's concern that it would not be transparent or equitable for the principles to be governed solely by the panel, Ofgem does not consider this to be a problem given that the panel members are drawn from, and represent the interests of, users in general and operate within the terms of the modification rules, which are themselves transparent.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct the relevant GTs to implement this modification as we do not consider that it would better facilitate the achievement of the relevant objectives of the UNC, as outlined under Standard Special Condition A11 of their GT licences.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'N Simpson', written over a light blue horizontal line.

Nick Simpson
Director, Modifications