

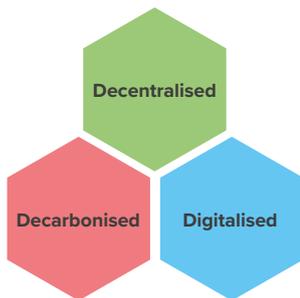
FUTURE ENERGY MARKETS: REFORMING OUTDATED GOVERNANCE



Gemserv

SUMMARY OF OUR REPORT ON ONE PAGE

Energy markets in Great Britain are facing a dramatic transformation, driven by changes in technology, policy and consumer expectations. Domestic consumers, communities and businesses are being empowered by new technologies to produce, store, and trade energy. New entrants and innovative business models are emerging, with open data likely to play a critical enabling role with end consumers benefiting from having greater competition and choice in their energy services.



Gemserv’s aim is to help create the energy markets needed for this exciting future. We are committed to driving improvement, engaging extensively with market participants, and publishing our ideas to shape the step change that is needed. While the current rules have been effective in supporting market developments since deregulation in the 1990s, they are now widely criticised as being reactive, complex, and lacking coordination – they need to catch up. We hope the Government’s Energy Codes Review will catalyse the changes we propose in this paper.

Transforming the rules and practices that define today’s energy market will be challenging - but action is vital if future energy markets are to work to increase competition,

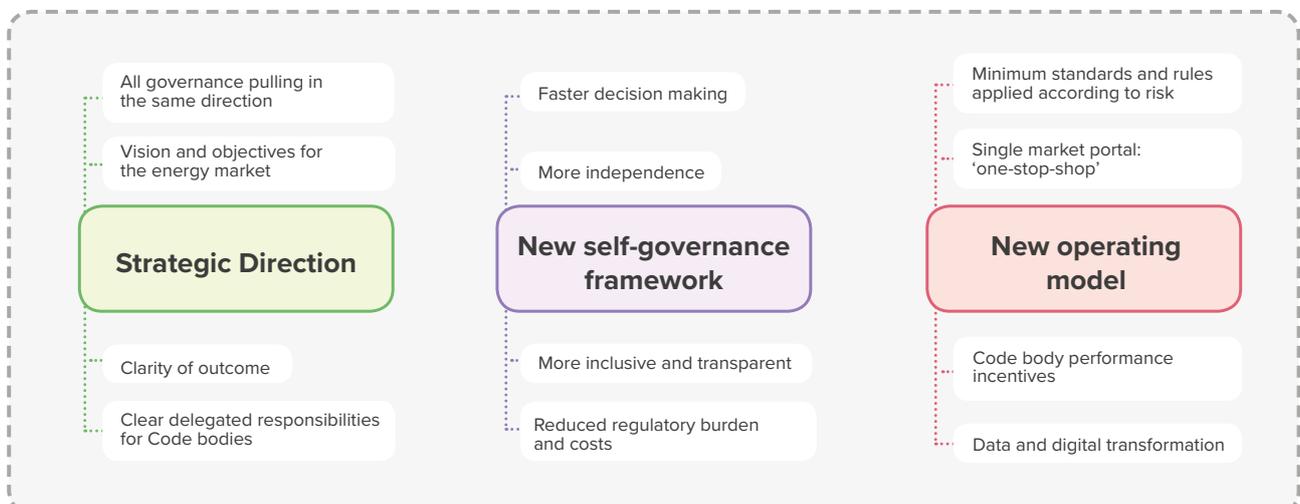
help reduce emissions and benefit end consumers. A fundamental step change is needed, but one that is practical to implement. Our vision is for an integrated change programme that comprises three key elements:

1. A clear **strategic direction** from Government and Ofgem, setting a vision and objectives for the future energy market, including clear delegated responsibilities for industry self-governance bodies for the first time.
2. A **new self-governance framework** that is aligned with this strategic direction and which provides clear accountability, transparency and faster more inclusive decision-making addressing the criticism of current systems.
3. A **new operating model** including a new risk-based approach to reduce regulatory burdens and costs, a single market portal to enable streamlined market entry for all participants and incentives for code managers for their delivery performance.

The above elements must be underpinned with clear transition plans – action plans that put new governance and operating models in place over appropriate timescales.

The forthcoming Retail Energy Code should help catalyse this transition by becoming an exemplary code with new thinking and process improvements, which could be mirrored across other codes and governance arrangements.

We believe this integrated approach will allow consumers to benefit from better energy market rules and practices that are more efficient and transparent than today. Other market participants – be they established supply businesses, new entrants, or start-ups – will also benefit from clearer more accessible governance arrangements with reduced regulatory burden and costs.



The ways in which future consumers can benefit from decarbonised, decentralised and digitalised energy systems are already evident. In-home digital assistants allow consumers to control home energy usage and participate in energy markets by storing, generating and trading energy. Electric vehicles will be used to charge and export power at any location, and the ‘whole’ energy system will increasingly span the power, heat and transport systems and extend beyond the meter.

Such applications will need market rules to more closely match the needs of individual buyers and sellers of these energy services. The pricing, measurement and settlement of energy production, demand and trades will need to develop accordingly.

While many improvements have been made, industry self-governance of codes and their administration remain complex, uncoordinated and slow to adapt. They present a potential barrier to new industry participants (including domestic consumers) and new business models.

The call for simpler, more flexible, more transparent energy market rules and practices is increasing. The Competition and Markets Authority (CMA) recommended improvements in its 2016 energy market review, as did the 2017 Helm report to BEIS on energy prices. The Energy Systems Catapult Future Power Systems Architecture programme has called for greater strategic oversight and agility, and Laura Sandys ‘Challenging Ideas’ has proposed a less prescriptive perimeter regulation regime.

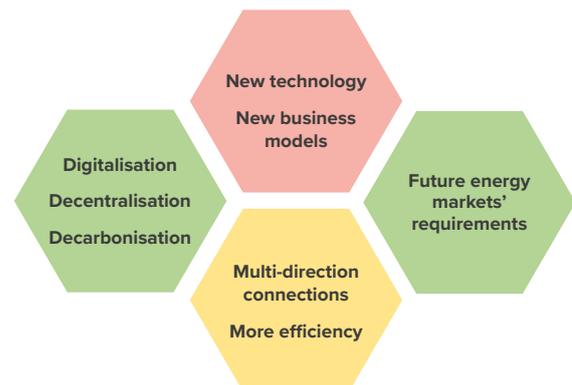
Following this, in 2018, BEIS and Ofgem launched a review of energy codes and their governance. BEIS is also undertaking an energy data review to understand what improvements are needed to enable competitive markets. Furthermore, Ofgem is introducing a new Retail Energy Code (REC) to improve retail switching and settlement.

Gemserv has been a leading voice in calling for reform and a transformation in industry governance - we have been engaging actively with new and existing industry participants to gain their views. This paper builds on our previous ideas and sets out our vision about how the rules and their administration should change to improve energy markets and benefit consumers in the future.

OUR VISION

The world has moved on. Future energy markets must adapt to:

- Decarbonising from fossil fuels
- Moving from centralised to decentralised
- Being more digitally connected and multi-directional
- Using open data frameworks
- Serving many more new participants and new business models
- Changing consumers needs whether vulnerable, actively engaged or disengaged
- More efficient market operation



We have developed suggestions for new design, governance and operating models that could enable a transition to this new market environment.

Our approach puts consumers first, whether they actively engage in this changing market or not. Consumers can benefit from selling output from solar panels, from increased choice and competition, from improved standards of service and from new pricing and service offerings. Key to unlocking these benefits is good market governance which we are looking to strengthen through the proposals in this paper.

Our vision is for an integrated change programme with the following key elements:

1. A clear strategic direction from Government and Ofgem for framework change:

- Setting out aims for future energy markets, defining required outcomes and implementation actions.
- A clear strategy will provide clarity for market administrators (such as delegated responsibilities and objectives for code bodies) and market participants alike.
- Helping to ensure a joined up approach to common market goals.

2. A new self-governance framework that is aligned with this strategic direction:

- Providing clear accountability, transparency and faster decision making.
- Addressing current issues such as accessibility to decision-making and self-interest of participants on decision making panels
- Increasing the powers of independent panel members.

3. A new operating model that delivers:

- Accessibility, transparency and simplification improvements.
- Code managers to be accountable and incentivised for their delivery performance.
- Simple 'one-stop' access for market participants through a new market portal.
- Targeted risk-based rules to reduce the regulatory burden.

Each of these elements must be co-ordinated to work effectively and deliver customer outcomes, with clear accountability for both co-ordination and delivery. Each of these component parts is discussed in the section below.



WE PROPOSE THAT BEIS AND OFGEM SHOULD CLEARLY OUTLINE THE STRATEGIC DIRECTION FOR ENERGY MARKETS AND THEIR GOVERNANCE.

STRATEGIC DIRECTION

Issue: Lack of clarity about the outcomes to be achieved through industry-led governance arrangements

Solution: Strategic direction setting out clear outcomes and roles and responsibilities

Benefit: Better decision making leading to improved consumer and market outcomes

BEIS and Ofgem should set out their vision for future energy markets. This should include governance and operational reform, aimed at enhancing the ability of all buyers and sellers (including consumers and their agents) to easily participate in these markets. Unnecessary barriers to market participation and rule change should be removed so that consumers can enjoy clean, affordable and reliable energy.

In order to ensure that codes and their administration can be aligned with these strategic goals, a high-level strategic plan should be developed to identify the future actions that will be required to remove barriers and prepare for expected future market changes. Furthermore, this strategic plan should be accompanied by the common key objectives (equivalent to regulatory principles for required behaviour) to be delivered by the organisations that are responsible for market rules and administration activities, providing clarity on role, responsibilities and delegated authority.

We think the policies set out by BEIS and Ofgem in this strategic plan should clearly identify preferred governance frameworks and objectives, together with the desired features of target operating models for market administration.

STRATEGIC PLANNING

We suggest this planning process should address the known deficiencies in code governance (such as potential self-interest of code panel members restricting change) together with the key market and technological factors that are expected to impact the code, industry process, and administration landscape over the next five years or so. This should address ongoing switching, settlement and open data recommendations, also enabling new market

developments such as the growth of electric vehicles and in-home energy management devices.

The plan should identify the specific actions to be taken by (and co-ordinated between) the industry participants, together with detailed delivery plans. It should be designed to target the key changes that are required to improve the current market rules, their governance and administration, and to design for the future.

The first strategic plan could be developed through the current BEIS/Ofgem Code Review. Such a plan could then be updated when required to reflect new market developments. This should provide a means for Government and Ofgem to provide a clear strategic direction and place accountabilities for delivery with industry governance and administration bodies.

COMMON OBJECTIVES

In order to implement this strategic direction, it is suggested that common objectives (and measurable outcomes) be defined. These should address:

- 1) Accessibility – exploiting data and technology to provide easy accessibility to new entrants and new service offerings to smaller participants as well as incumbents
- 2) Decision making - taking fast and fair rule decisions while ensuring energy markets remain robust and resilient
- 3) Flexibility to design and deliver timely rule and process change
- 4) Delivery of process and compliance services in a timely way with good customer service
- 5) Cost and efficiency of market administration processes – improvements such as new digital tools to provide value for money services
- 6) Coordination between code bodies and managers to develop optimal solutions

A performance framework may be established around these objectives for all code bodies and managers with independent assessment and delivery incentives. The achievement of all these objectives should ultimately lead to consumers benefiting from greater competition and choice.

A common objective-based approach applied to all administration bodies should aid coordination and consistency. It could also encourage consolidation of both decision-making bodies and administration bodies over time.

8 NEW SELF-GOVERNANCE FRAMEWORK

WE PROPOSE THAT DECISIONS ABOUT ENERGY MARKET RULES REMAIN UNDER INDUSTRY SELF-GOVERNANCE.

NEW GOVERNANCE FRAMEWORK

Issue: Complex, slow and biased to incumbents; barriers to new entrants and business models

Solution: Reform the way code panels operate, for example with the introduction and increased authority of independent members

Benefit: Faster, responsive decision making

The main options for governance or control of rules and decision making may be considered as:

- Devolved control, where rules are developed and implemented through industry self-governance arrangements (essentially the current situation)
- Central control, where an existing or new body is responsible for strategic and operational decisions, enabling coordination. This could be a new code agency, potentially accountable to Ofgem or BEIS.

A history of devolved control has resulted in the challenges that we face today, but does bring the advantages of advanced knowledge and capabilities offered by industry participants. If current arrangements were to be replaced by a new centralised body it would likely take a considerable time to replace this knowledge and experience, exacerbated by the expected dynamic nature of future energy markets.

We propose that code decisions and process administration should be delegated wherever possible, subject to safeguards being in place. Industry self-governance of codes should therefore be retained but with a more inclusive, responsive and flexible approach than before. Code panels and code managers should be more proactive, responsible for developing future change proposals and plans to improve the efficiency of market processes in accordance with the new Strategic Direction we propose above.

A regime of principle and risk-based regulation should be introduced which captures the benefits of devolution and industry experience while enhancing strategic control and oversight by Ofgem/BEIS. It would also ensure more proportionate and targeted rules, which overall would reduce the regulatory burden on market participants.

Once this a regime is operational, it offers the opportunity for common objectives to be established for each of the code bodies. This should enable a consistent approach across the various entities expected to be responsible for code decisions and delivery administration. It would enable Government and Ofgem to retain the benefits from industry self-governance, but within a more comprehensive and proactive regulatory framework.

Such an approach could be allied with the development of the new REC and the potential consolidation of other codes. If, for example, simplification ideas are taken forward for the creation of three industry codes for retail, wholesale and networks, then the code panels and administrative bodies involved could be required to collaborate to achieve this consolidation.

In determining the right number of codes and code panels, we think that the best way of implementing the common objectives should take priority over individual uncoordinated reforms by individual code panels or code managers.

DECISION MAKING

In order to ensure that the code decision making panels are not unduly influenced by self-interest groups, it is proposed that an independent Chair and a majority of independent members are appointed (with Ofgem/BEIS approval). These independent members should have increased authority to ensure that the panels achieve the outcomes which have been set through the Strategic Direction, as well as plan for and deliver their decisions effectively.

The role of the Code Manager will be critical in supporting the Panel Chair in delivering the strategic direction through effective planning and analysis of market rule change and delivery of those changes.

Measures to speed up decision-making and co-ordination include, early identification of issues and preparatory analysis, engagement with stakeholder groups, the use of agile development techniques and co-ordination across other code bodies and interested parties. Criteria and voting arrangements for decision making should also be regularly reviewed to ensure they are fit for purpose. Flexibility will be key - for example, when matters are of particular interest to some smaller participants, the members of decision-making groups should be changed to include the relevant representatives so that faster decisions or recommendations can be reached.

A key requirement of effective governance is that potentially controversial and difficult decisions can be taken in a timely manner. Government and Ofgem should have the ability to provide strategic direction to code panels while not having detailed operational direction for code panels to implement in such cases.

Whether decisions are taken by code panels or by Ofgem following panel recommendations, appeal processes will be necessary to resolve disputes. To speed up appeals, an expert arbitration panel could be used instead of referrals to the CMA.

WE PROPOSE A NEW OPERATING MODEL THAT WILL ENHANCE ACCESS TO MARKETS AND IMPROVE ADMINISTRATION PERFORMANCE.

NEW OPERATING MODEL

Issue: Complex and uncoordinated market processes; barriers to new entrants and business models

Solution: New target operating model with one-stop-shop market portal and risk-based rules

Benefit: More efficient market operation; reduced regulatory burden for market participants

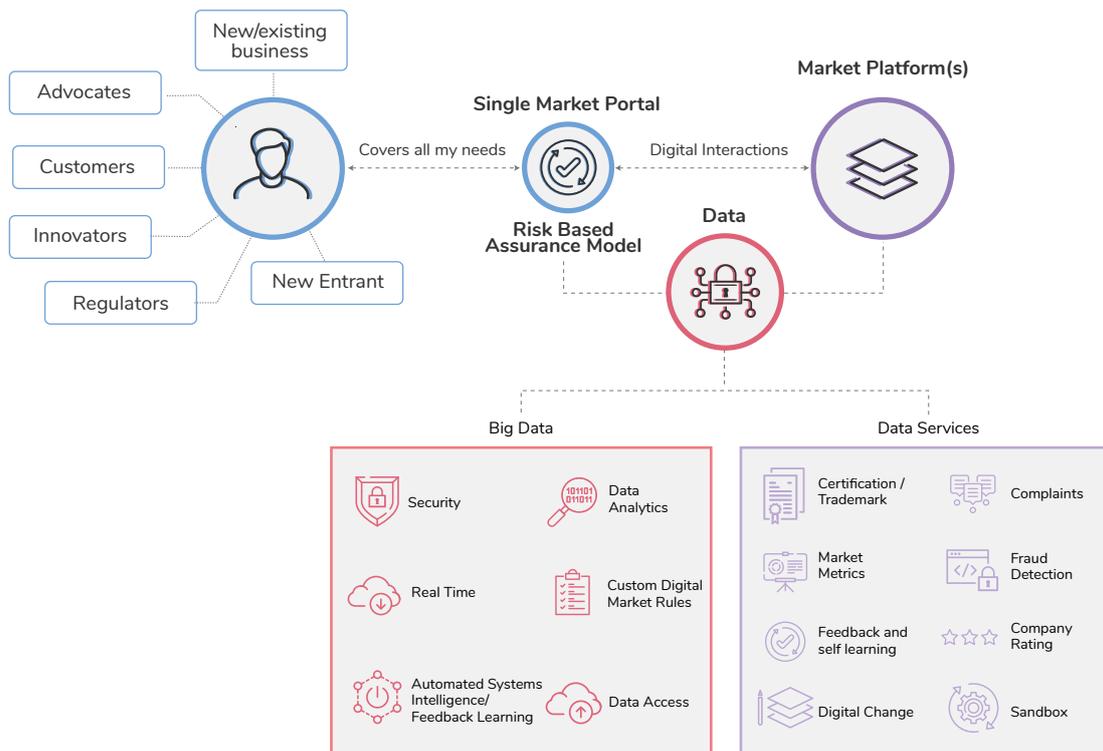
This operating model should be aligned to deliver the principle and risk-based regulatory framework described above, while also ensuring that practical implementation and transition issues are considered as part of the market rule decisions.

We have designed a new target operating model powered by data and digital capabilities to enhance the accessibility and flexibility of market rules and their administration.

As illustrated below, this design aims to combine data and digital technology to provide a flexible, accessible and efficient operating model that may be applied to all code and industry administrative processes. Using secure digital technology, we can deliver an integrated whole market approach with consumers at its heart. This approach can address Ofgem’s aim for new codes to have a digital transformation impact.

The key features of this operating model are:

- **Single Market Portal** - a single access portal for market participants.
 - This would be a one-stop-shop across all codes, regulation and licensing, reducing the burden of dealing with multiple organisations and rule books.
 - New market participants would be able to register their business model and receive permission to operate through this single interaction point.
 - Over time the portal could develop into a single source of authoritative industry data, and provide market monitoring and assurance and other services such as certification and company rating information.



- **Risk-Based Rules:**

- There would be minimum standards for all market participants, many of which could be principle based, with any additional rules applied according to the risk that they pose to the market.
- In practice this could mean a higher bar to market entry, for example to safeguard consumers if there are weaknesses in a new entrant's business model, as well as additional operating requirements, for example, more frequent reporting obligations and financial guarantees. However, overall this approach would reduce the regulatory burden and costs on participants.

- **Data and Digital Transformation:**

- Building on automation and growing this via machine learning and Artificial Intelligence (AI), we can harness the power of data and deliver more efficient digital systems that improve engagement and reduce business costs.
- In its simplest form this could be a truly digital code, a machine readable, consolidated rule book enabling tailored rules for the needs of individual market participants.
- Over time, greater use of data and technology would help bring increased automation to managing the risk-based approach through the market portal.

PERFORMANCE INCENTIVES

Incentivising code panels – code panels should be required to report on their performance against certain metrics e.g. speed of decision process. Given the need to maintain their independence, it is suggested that the main incentive for a code panel should be reputational rather than financial. Ultimately, a poorly performing code panel could be replaced by Ofgem.

Incentivising code managers – certain incentives could be set ex-ante, for example, rewards for customer satisfaction, process delivery, and outcomes that can be monitored. The rewards or penalties would be part of the funding arrangements. Ex-post assessments of performance may be performed by using independent assurance.

Incentivising market participants – certain incentives could also be offered to market participants, for example, streamlined access to processes, lower compliance requirements and participatory costs in return for demonstrating good performance over time. Conversely, market participants that demonstrated non-compliance or poor performance may face additional processes and costs, all as part of a well functioning risk-based approach to regulation.

WE PROPOSE THAT TRANSITION PLANS SHOULD BE LED THROUGH THE DEVELOPMENT AND IMPLEMENTATION OF THE RETAIL ENERGY CODE (REC).

TRANSITION

Issue: Complexity and cost of change; risk of disruption to existing markets

Solution: A phased approach to reform using the REC as an exemplary code and catalyst for change

Benefit: Delivery of strategic aims and a more effective and efficient governance framework and market rules

One of the key reasons why change from the current framework has been slow is that transition is complex and difficult. Therefore, the above elements must be underpinned with clear transition plans – action plans that put new governance and operating models in place over time, building the new capabilities to improve the performance of energy markets. These should set out the implementable actions needed to commence the transition.

It is essential that governance and code transition plans should be designed to retain confidence in energy markets, while also ensuring that the necessary skills and capabilities are in place to successfully deliver the transition. Setting a new framework on its own is unlikely to be sufficient. Action will also need to be undertaken to remove barriers and develop a new operating model.

In order to enable the desired whole energy market transformation, the new operating model for market rules and their administration will need to become better, cheaper and faster than before. The new regime will need to be accessible to existing and new participants alike, agile enough to enable responsive change and to be trusted by all market participants.

The REC can be an exemplar for new thinking and process improvements to be trialled and then pursued further across other codes and operational designs. This ‘pilot’ approach will allow lessons to be learned and further improvements sought thereafter. Based upon the existing proposals for the REC to be used as the first area for code governance and process redesign, we suggest the following is applied:

- A strategic plan is developed by Government and Ofgem which sets out the goals for retail markets over the next five years and plans for their implementation through the REC
- Enabling legislation is put in place so that future reforms of codes and code manager responsibilities can be quickly implemented in future
- Common objectives are set for parties responsible for delivering REC decisions and associated administrative processes, including responsibilities for co-ordination
- Once appointed, the REC panel and code manager should prepare detailed plans for further improvement of market rules and processes in line with these objectives
- The performance of the REC code panel and code manager should be independently assessed against these objectives taking due account of stakeholder views and consumer outcomes.

This approach may then be used for subsequent application to other codes, allowing potential for consolidation of code managers and processes to also be evaluated. A phased approach should limit the risks associated with a major cross-industry transformation initiative and reduce the impact on valuable resources. The transition plan for the REC should also allow for future development options to be considered and evaluated such that they may be scheduled and phased in later years.

Delivery of the transition plan for the REC and other codes will be a major project in its own right and it will be important that appropriate governance, resources and project management is allocated for this work.

We believe a fundamental change is needed to industry governance and administration. We propose that this change includes the following five integrated elements:

- 1. A strategic direction should be developed by BEIS and Ofgem, that can address future challenges as well as current problems.**
- 2. A new industry self-governance framework should be created to align with this strategic direction, to be faster and more adaptable to address future market change.**
- 3. Improved operating models should be developed to offer simpler access to rules and administration services, incorporating risk-based rules, a single portal, digitalisation and performance incentives.**
- 4. Using the REC as an exemplar of good practice, transition plans should roll-out the new governance and operating models, building the new capabilities to improve the performance of energy markets.**
- 5. The Government's Energy Codes Review, forthcoming White Paper and the implementation of the REC together offer a great opportunity to start this transformation.**

We believe this holistic approach should allow consumers to benefit from trusted energy market rules and practices that enable greater participation across a much wider energy system and are more efficient than today. Our ideas can address both current and future challenges.

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LONDON OFFICE

8 Fenchurch Place
London, EC3M 4AJ
Telephone: 020 7090 1000
info@gemserv.com

IRELAND OFFICE

Fitzwilliam Hall Business Centre
Fitzwilliam Place, Dublin 2
Telephone: +353 (0) 1 669 4630

