



SHEPHERD+ WEDDERBURN

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THE MARKET CODE: KEY ISSUES

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A. OVERALL APPROACH TO DEVELOPING THE MARKET CODE

Process

The Market Code was developed by the Water Industry Commission for Scotland (the Commission) in consultation with industry participants as part of the wider licensing project. The Commission recognised from a fairly early stage that there was a need for some form of multilateral code that dealt with:

- customer switching;
- volume allocation;
- charge calculation; and
- information flows among market participants.

The core objectives for the Market Code and the principles that govern its scope and interpretation were defined by the Commission during the consultation process. Development of the more detailed content of the Market Code, however, came at a relatively late stage in the wider licensing project.

The Commission's November 2005 consultation began to sketch out the possibility of a Market Code being developed and respondents agreed with the need for industry involvement in that process. The Licensing Framework Implementation Group (LFIG) was established in Spring 2006 in response to this with the first meeting held in Summer 2006. The Commission decided at this time to develop the Market Code through the LFIG.

With market opening scheduled for Spring 2008 this may seem a generous timeframe but the detailed market design for the settlement systems that underpin the Market Code and the detailed development of the market rules were significant tasks. As we identified the need to have the Market Code ready for "Go Active" in September 2007 (to allow market participants to become familiar with the rules, test their market readiness etc), this meant that, in practice, the Market Code was developed via the LFIG process in just over one year.

Timing

There were two key drivers in the wider licensing project that unlocked our ability to develop the detailed Market Code rules.

Firstly, the appointment by the Commission of Gemserv to develop and build the central systems required to support:

- customer switching;
- volume allocation;
- charge calculation; and
- information flows between the Central Market Agency (the CMA) and market participants.

On appointment in October 2006, Gemserv had to develop the baseline documents confirming how the switching process would work. It is hard to overstate the importance of getting to that stable point on this project in terms of market design (or any other project involving software/systems development). There was therefore a period of intense activity as the Commission worked with LFIG and Gemserv to confirm the rules and detailed processes that were appropriate for customer switching and to do so in a manner that was simple and proportionate to the size of the market. Shepherd and Wedderburn were heavily involved in



that process. The Market Code was to be published for consultation in January 2007 and we needed to move to drafting its core technical content as quickly as possible.

Secondly, Scottish Water were under an obligation to prepare a wholesale charges scheme (under Section 29 of the Water Industry (Scotland) Act 2002) and submit this to the Commission for consultation and approval. This charges scheme defines the charges that Scottish Water will levy on retailers for the wholesale water and sewerage services provided to them by Scottish Water. The dialogue between the Commission and Scottish Water on this topic and pinning down the final drafting of the charges scheme took some months. This meant that Gemserv and Shepherd and Wedderburn had to develop the underlying central systems and the Market Code drafting in parallel with the development and finalisation of the charges scheme.

A third key process point was the development of the non-technical parts of the Market Code. It took time to address some of the key policy issues and document these in as straightforward a manner as we could muster. Good examples include developing the change control regime for the Market Code and identifying the right balance of rights and duties among the CMA Board, the Technical Panel (the Market Code governance panel) and the Commission. Similarly, we had to define some form of performance monitoring regime for the new market and a sensible and proportionate approach to dispute resolution. We drew from experience in other regulated sectors in all of this but were keen to be mindful of the wish for a relatively simple and proportionate market solution that was relevant to the structure and size of the water and sewerage services market.

The key messages are therefore that;

- developing the central systems and the legal drafting in parallel was challenging and demanded strong version control within the project team;
- the relatively late arrival of an approved approach to wholesale charging meant many of the detailed charging related processes were developed late in the licensing project; and
- it was important not to underestimate the time needed to develop well considered policy approaches to key issues such as governance in consultation with the LFIG industry body.

Consultation

In addition to developing the Market Code via the LFIG, the Commission carried out three key consultations on the draft Market Code in January 2007, May 2007 and August 2007. Late developments from the licensing framework around self-supply licences and specialist licences led to the introduction of new legal drafting even in the last consultation version of the Market Code. Market Participants wishing to enter the market and ready to do so at that time signed the Market Code in September 2007 and moved through the market testing process in the run up to full market opening in Spring 2008. They therefore had relatively limited time to become familiar with the Market Code and its various subsidiary documents and to ensure that they were “market ready”.

Other developments over this period included the introduction of an ability for retailers who had obtained a licence in the run up to Go Active to enter into pre-contracts with customers with a view to these being effective immediately on Go Live. We therefore worked with the Commission, Gemserv and LFIG to develop a simple process for retailers to pre-register customer Supply Points and for these to be transferred into the full settlement register on Go Live.

All of this activity and the consultation process via LFIG and Commission consultation documents produced a significant amount of documentation for market participants to absorb over a relatively tight timescale. This emphasised the need to keep the Market Code and its supporting documents as straightforward and transparent as possible.



B. ANATOMY OF THE MARKET CODE

The Market Code is made up of three main types of document.

The front end of the Market Code contains most of the legal drafting divided into ten parts and covering commencement plus the important objectives and principles, CMA duties, Licensed Provider (i.e. retailer) and Scottish Water duties, market design, performance standards, cost recovery, governance, disputes procedure and general boilerplate including default and resignation.

The first few schedules contain further legal text covering definitions, provisions relating to the establishment of the CMA and its possible replacement by a similar market body in future, accession documents for new Licensed Providers and some transitional arrangements relevant to Go Active/Go Live.

The remainder of the Market Code is made up of 19 Code Subsidiary Documents (CSDs). These are largely in the format of process diagrams or flow charts with simple tables setting out the steps that apply for each process e.g. registering a Supply Point, submitting meter reads, calculation of the volumes of water and sewerage services taken by a particular Licensed Provider.

Part 1 refers to the Market Code objectives which are:

- (a) To enable the registration of data concerning eligible customers or eligible premises which is or may be relevant to the provision of licensed services;
- (b) To enable the transfer of eligible customers from one licensed provider to another;
- (c) To enable the calculation of charges to be recovered by Scottish Water from licensed providers;
- (d) To make provision in respect of the amendment of the Operational Code; and
- (e) To make provision for any related transitional, supplemental and ancillary matters.

Part 1 also refers to the principles of the Market Code which are:-

- (a) **proportionality** - the rules and arrangements established by or under each core industry document should be proportionate within the context of their respective objectives; in particular, those established by the Market Code should be proportionate to the size of the market for the provision of licensed services and the anticipated number and frequency of transfers of eligible customers for the provision of licensed services from one Licensed Provider to another;
- (b) **transparency** - the rules and arrangements established by or under each core industry document should be concise, clearly expressed, well-structured and readily accessible to both existing and prospective Licensed Providers;
- (c) **simplicity, cost effectiveness and security** - the systems and processes established by or under the Market Code and Operational Code should be as straightforward and as economical as possible (whilst being capable of development over time) and should contain appropriate data integrity and security controls;
- (d) **non-exclusivity** - the rules and arrangements established by or under the Market Code should be sufficiently clear, simple and cost effective, to support the majority of trading activity in the market for the provision of licensed services whilst allowing for relevant identified activities to be carried out, on a bilateral basis, outwith the scope of the Market Code;
- (e) **barriers to entry** - the rules and/or arrangements established by or under each core industry document should not create barriers to entry in respect of the market for the provision of licensed services;
- (f) **customer contact** - the rules and arrangements established by or under the Operational Code should ensure that, save in exceptional circumstances, the primary contact with each eligible customer should be interfaced through the relevant Licensed Provider;



- (g) **non-discrimination** - the rules and/or arrangements established by or under each core industry document should not unduly discriminate, or create undue discrimination, between Licensed Providers; and
- (h) **core functions** - the rules and/or arrangements established by or under each core industry document should not be detrimental to the exercise of Scottish Water's core functions.

Changes to the Market Code must fall within the scope of the objectives and be consistent with the principles. The objectives and principles were established by the Commission under a Section 11 Direction and therefore may only be amended by the Commission following consultation as required under Section 11.

Part 2 clarifies that the CMA's role is to provide the facilities, resources and services needed for the effective implementation of the Market Code. The remainder of this Part then provides a little more detail on that and signposts the parts of the Market Code that are relevant to the CMA. Parts 3 and 4 take the same approach for Licensed Providers and Scottish Water – they flag up to each participant, which parts of the Market Code are particularly relevant to them.

Part 5 covering market design is somewhat different in character. We set out here to give a reasonably high level description of what the central systems do – therefore you will see reasonably detailed summary information about how to register and switch customers and about how the CMA uses the systems to calculate volumes and charges. This was a difficult balancing act – we wanted to give market participants an initial understanding of these issues but of course also referred to the detailed process diagrams and step plans set out in the relevant CSDs.

Part 6 covers performance standards – both the standards required from market participants, the process for monitoring performance and charging market participants when they fail to meet standards on a capped basis.

Part 7 set out the basis on which CMA Charges are budgeted for and paid by industry members – essentially split one third to Scottish Water and two thirds shared amongst Licensed Providers.

Part 8 sets out the detailed governance arrangements – the make-up of the CMA Board, the role and make-up of the Technical Panel and the Commission's role in the change process. This Part also confirms that the same group of individuals will make up the Technical Panel responsible for Operational Code changes. This was a key policy issue in that the Commission were keen to ensure that each Code did not become a decision making "silo" and that where issues cut across both documents they could be dealt with efficiently.

Part 9 contains the disputes procedure which we developed with a view to ensuring that issues arising under the Market Code and/or the Operational Code could be combined and dealt with efficiently in one process.

Part 10 addresses the liability of market participants towards each other, confidentiality, termination arrangements for both the CMA or any other market participant and some other boilerplate matters.



C. KEY ISSUES

As already noted we faced a range of issues both at a policy level and in terms of detailed technical drafting and systems development. Here are some examples of key points that took time to address and resolve via the LFIG and wider consultation process.

Provider of Last Resort (POLR)

Prior to the Market Code being signed the Commission consulted on the basis that, where a retailer defaults and is required to leave the market, their customers would be re-allocated to other retailer at the discretion of the CMA. Respondents to the consultation sought more clarity on who customers would be allocated to in these circumstances. When the Market Code first came into effect at Go Active it, therefore, provided for the CMA to bring forward a detailed proposal setting the rules for allocating customers in this scenario but also set out a fall back, default process that would apply from day one. The POLR allocation process has effectively now developed into an evenly shared allocation process with the specific customers going to each Licensed Provider being selected on a random basis by the CMA. A further change has also been introduced to allow for Licensed Providers to opt out of taking customers in these circumstances provided their market share is below 20%.

This is therefore a good example of policy developing via the Commission's consultation process with industry and the Commission also recognising the value of giving market participants a strong voice in the ultimate terms developed for the Market Code by providing for changes to be introduced after market opening via the Market Code change process.

Multiple Occupancy Sites

This was an issue of a different character in that it was highly technical in nature. The Supply Point is the "unit" which can switch retailers under the switching mechanism and a Supply Point will be for either water services or sewerage services – it became clear relatively late in the drafting process that the Supply Point definition (already reasonably complex as it addresses premises with both Water and Sewerage Supply Points, only one or other etc) did not adequately address some of the issues raised by multiple occupancy sites. The issue was identified when reviewing the customer data feeds provided to the CMA from Business Stream and therefore we needed to find a quick fix. We took that view that further complicating the Supply Point definition would bring potential confusion to the drafting – we therefore developed a stand-alone provision for Part 5 setting out the rules for handling multiple occupancy sites.

Performance standards

The Commission realised relatively early in developing the Market Code that setting coherent standards for each type of market participant that were worth monitoring and enforcing was next to impossible before we had experience of the market and systems operating in practice. The Commission via the LFIG process therefore adopted some early indicators of performance and included language in the Market Code allowing for these indicators to be monitored with a view to the CMA Board coming forward with full performance standards and performance standard charges in due course.

This was a good example of a key learning point in developing the Market Code and other core industry documents. The Commission recognised that it should deliver a set of documents that were "market ready" but that they did not require to cover every possible issue at Go Active. At

that point in time, the Market Code's own governance procedures would kick in and the Market Code would continue to develop over time under the guidance of the industry participants on the Technical Panel. We were therefore producing a document fit to be the starting point of a journey that would see the market develop and evolve over time.

Governance

There was considerable discussion over a governance regime that was fit for purpose for our market. That debate both within the Commission, through the LFIG and consultation process and latterly with the CMA itself lead to the following key provisions in the Market Code:

- The CMA Board – this has up to 2 Licensed Provider selected directors, 1 Scottish Water director and up to 3 non-executive Directors appointed initially by the Commission and now by the Chairman of the CMA. The first Chairman was also appointed by the Commission and this will be a Board decision in future. The role of the Board is clearly the stable operation of the CMA as a not for profit organisation that fulfils its duties under the Market Code. In addition the Board authorises and appoints the market auditor, approves the CMA budget, approves market audit reports, confirms completion of market entry processes, provides a forum for discussion of settlement system issues, authorises enforcement action against a defaulting party and approves the release of data under the terms of the Market Code.
- The Technical Panel – this is made up of a single representative of each Licensed Provider and of Scottish Water. The CMA Chairs the meetings but has no vote and the CMA's Chief Executive and a representative of the Commission can attend meetings but not vote. The Technical Panel is responsible for keeping the contents of the Market Code under review and considering change proposals, voting on change proposals, commenting on the draft CMA budget and receiving compliance reports. Voting is by qualifying majority depending on the number of Licensed Providers in the market at the time.
- The Commission – the Commission has a limited role in Market Code governance – it receives the Technical Panel recommendation on each change proposal and has a right to veto changes only if they fall outwith the objectives or are inconsistent with the principles of the Market Code. In addition the Commission can promote changes to the Market Code where necessary to secure the orderly participation of parties in the market.

Through these provisions the Commission sought to create a framework within which market participants play an active role in developing changes and improvements to the market design whilst at the same time recognising that there are times when a regulator will need to step in if the market is not functioning in an orderly manner.

Default and liability

The Commission and Shepherd and Wedderburn reviewed the approaches to liability taken in industry codes across a number of other sectors – we drew on their experience but again developed our own approach to keep matters simple and transparent for this market. Performance Standard Charges achieved a degree of tension on all market participants to ensure their actions were compliant with the key aspects of the Market Code and settlement systems. The liability regime addressing other breaches of the Market Code therefore:

- is drafted in very simple terms – market participants are liable to each other for the direct losses that arise from their breach;
- applies a defined cap in most cases of £750,000 for any Licensed Provider or Scottish Water liability; and



- in the case of the CMA states that they are a not for profit body without liability to the market with the exception that if a market participant is unfairly and particularly prejudiced by CMA actions they may make a claim for up to £750,000.

D. POST MARKET OPENING CHANGES – A DEVELOPING MARKET

Since market opening there have been approximately 100 change proposals brought forward to the Technical Panel and around one third have been approved as changes to the Market Code. This suggests that the Technical Panel is operating to filter out unnecessary change but is willing to act when necessary.

The initial changes made in the immediate aftermath of market opening focussed on tidying up aspects of the Market Code and correcting defects or plugging gaps identified in the market design once fully operational. Market Entry Processes are a good example. Relatively late in the systems development process it became clear that Licensed Providers may have a high volume of trades on a regular basis or a low volume depending on their role in the market. At Go Active/Live the market entry testing processes were geared towards the more complex high volume users of the settlement service. This led to an early change being introduced via the Market Code change process in August 2008 to allow for a process of self-certification for low volume users. This was a very practical matter aimed at ensuring the entry processes were not a barrier to entry for some Licensed Providers.

Similarly the Market Code had allowed for gap sites unregistered in the central systems to be registered by application of Licensed Providers. This was amended to provide for Scottish Water bringing forward gap sites following market opening. It was clear that the data sets on which the supply point register was based were not as comprehensive as had been hoped and that Scottish Water should be permitted to identify and add sites to the register.

Building on that base, changes have since moved more into the territory of market improvements. For example, the basis on which Licensed Providers pay CMA charges has become more representative of volume market share rather than number of customers, the performance standards regime has been reviewed and developed as envisaged at market opening, Licensed Providers are permitted to opt out of the gap site allocation process and the POLR process if their market share is below 20%.

E. LESSONS LEARNED

Key lessons learned in developing the Market Code were therefore:

- baselined technical descriptions of the switching process, volume allocation and charging were needed early to facilitate systems design and code drafting;
- strong change control was needed for the technical suppliers and the lawyers to ensure the systems and code did not drift apart;
- precedents from other industry sectors and codes are useful but should not be adopted without tailoring to the specific needs of this market;
- it takes time to address key issues of policy;
- it takes time to document those issues once settled;
- it takes time to provide transparency and consultation to industry participants; and



- industry participation in Code governance will ensure the Market Code develops over time – the Go Active/Live version will never be perfect and a lot of time can be lost in pursuit of the ideal market document.



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