ELEXON

16 January 2023

By e-mail to: DCCregulation@ofgem.gov.uk

Dear DCC Oversight and Regulatory Review team,

Re: DCC review: Phase 1 consultation

Thank you for the opportunity to respond to the DCC review: Phase 1 consultation.

Elexon is the Code Manager for the Balancing and Settlement Code (BSC), which facilitates the effective operation of the electricity market. We are responsible for managing and delivering the end-to-end services set out in the BSC and accompanying systems that support the BSC. This includes responsibility for the delivery of balancing and imbalance settlement and the provision of assurance services to the BSC Panel and BSC Parties (energy Suppliers, generators, flexibility service providers and network companies). We manage not just the assessment, but also the development, implementation and operation of changes to central systems and processes. In addition, our expertise is available to support the industry, government and Ofgem in considering future changes and innovation against the existing industry rules, for the benefit of the consumer. Elexon is a not-for-profit company, currently set up as an arms-length subsidiary of National Grid ESO (Electricity System Operator).

In addition, through our subsidiary, EMR Settlement Ltd, we calculate, collect and distribute payments to Contract for Difference (CfD) generators and Capacity Market (CM) providers, on behalf of the Low Carbon Contracts Company (LCCC). These services are provided to LCCC through a contract and on a not-for-profit basis. EMR Settlement Ltd is also the Nuclear Regulated Asset Base Model Revenue Collection agent for LCCC.

Please below find the summary of key points in our response. We believe Option B (an alternative model based on more significant changes to the regulatory arrangements for DCC) presents a better fit with the future energy system and the expected prevailing regulatory, governance and ownership models in the central services space in place by 2030. Therefore, our preferred model is Option B; however, in our response we have suggested ideas for both options, in the event that Option A is decided upon:

Option A

- We recommend that there should be ring-fenced financial incentives to drive efficient and value-driven behaviours
- We support DCC being fully funded by users, with shareholder capital considered in exceptional circumstances such as delivery risk, alongside appropriate checks and balances.
- There should also be appropriate oversight to ensure third-party providers are delivering an efficient and high-quality service

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- We support empowering existing Board Directors to work with industry to appoint industry, independent and consumer representatives onto the DCC board.

Option B

- We believe that more robust budget control mechanisms need to be considered to manage the large DCC expenditure (around £500m annually)
- We agree with the notion of accountability to DCC users negating the need for an incentive structure, which, in any event, sits less well in a not for profit structure
- There need to be robust checks and balances on management of supplier contracts to ensure value from procured parties at lowest cost to the consumer
- There needs to be a process in place, which means Directors can meet their statutory responsibilities and liaise with Ofgem should any potential conflicts with the law arise
- There should be a mechanism in the contract to prevent Directors acting in the interest of their employer companies.

Whichever option is chosen, we recommend that Ofgem consider Market-wide Half-hourly Settlement (MHHS) as a critical dependency for the transition period as a smooth handover is critical, given the DCC's central role in MHHS, to ensure there is no knowledge or skills lag for enabling the delivery of MHHS alongside the Smart Meter Rollout.

We have limited our response to areas where we feel we can add value. If you would like to discuss any areas of our response, please contact Mahamid Ahmed, Strategy & External Affairs Manager (Mahamid.Ahmed@elexon.co.uk).

Yours sincerely,

Simon McCalla
Chief Executive Officer

Elexon's consultation response

Question 1: Which of the two broad models do you think we should adopt as the basis for our design of the future regulatory framework for DCC and why? What are the features of your preferred option that lead you to this choice?

We believe the choice of the future model for the DCC should be based on several key factors, namely:

- The design of the future energy system needed to deliver net zero
- The prevailing regulatory, governance and ownership models in the central services space in place by 2030 and beyond
- Best practices and verifiable evidence

The design of the future energy system needed to deliver net zero – This work is ongoing and will reflect a number of different building blocks, for example, the ongoing work to establish a new publicly-owned FSO (Future System Operator) and to grant Ofgem more powers under a new role of a Strategic Body for energy codes.

Additionally, more evidence and suggestions have come from the Net Zero Review, in the final report, published January 13th 2023. The review has suggested ideas pertaining to and highlighting the importance of the FSO, MHHS and Smart Meter rollout – for example it has recommended continuing to set ambitious targets for the remaining four years of the smart meter framework. Going forward, it will also be critical for BEIS and Ofgem to take into account the objectives of the Energy Code Reform and the emerging thinking on code consolidation and central systems delivery as part of wider Net Zero and Energy Regulation/Strategy government reviews.

One of the objectives of the Energy Code Review is to facilitate the delivery of strategic change. Consolidated codes and corresponding central systems should support the delivery of future strategic change and industry reforms that benefit consumers, including the delivery of the strategic direction that will be set by Ofgem in its new capacity as the Strategic Body.

The prevailing regulatory, governance and ownership models in the central services space in place by 2030 and beyond – Within the current central industry arrangements, there is a mixture of different business models (for profit, not for profit, licensed, unlicensed). The Code Change review is seeking to bring more control into this in order to achieve net zero by 2050. At the same time, we believe the more similarity between the central bodies' governance, ownership and control models, the more coherent the change will be, as those bodies will be acting based on the same motivation. We notice that the most recently established code body – Retail Energy Code Company, is a not-for-profit entity owned by industry parties. A similar model is being considered for the future ownership of Elexon.

Best practice and verifiable evidence - Any future changes should be firmly based on evidence, best practice and cost-benefit analysis. Where verifiable best practice exists, this needs to be taken into account and built upon to aid the overall transition to net zero and maintain stability of market arrangements.

Based on the above, the FSO implementation programme, and the Energy Code Review, we believe ownership options under Option B (All or a subset of SEC & REC Parties; Public ownership; One or more specific industry parties) should be explored and considered further.

The following features of Options B present a stronger potential for the future DCC to contribute fully to the objectives of ongoing energy industry transformation:

- Accountability & Control – Being controlled by stakeholders/customers with oversight from Ofgem
- Cost control and incentives – Budgets determined by the Board with stakeholder and customer consultation
- Funding – Funded by industry charges, borrowing allowed at low cost and risk capital raised for ring-fenced activities with project finance arrangements

Question 2: Do you agree with the way we have applied the principles in our analysis of the options? Please state your reasoning

We agree with the principles of the DCC review:

- Drive delivery of a quality, cost-efficient and secure service
- Be customer-centric and consumer-focused
- Enable full accountability and decisive governance
- Allow DCC's role to evolve in an uncertain environment
- Maximise the value of DCC infrastructure by enabling the exploration of assets subject to appropriate control mechanisms.

We detail some further considerations for both models in our answers to Question 3, 4 and 5.

Question 3: With regard to Option A, to what extent do you think that changes to the DCC licence alone could provide incentives that result in a third party investor-controlled DCC Board providing the quality and cost of service that DCC customers require, and managing DCC effectively?

In the past round of the Energy Code Reform, Elexon has proposed that there should be a fundamental review of how the industry arrangements are funded and managed. This is because there are a number of different funding models and governance arrangements across the sector, ranging from not-for-profit, to commercial, to Price Controlled (in the case of DCC). In our view, each of these models drives different behaviours and places different costs on the industry and the consumer. We welcome the inclusion of Option B, which looks at a more fundamental reform of DCC governance.

Should Option A be preferred and chosen as the future foundation for DCC governance, we believe there are a number of improvements that are being considered under the consultation which we would support. Below we detail our views for the suggestions proposed under the consultation:

OPTION A

Category		Category Description (from the Consultation document)	Elexon's View
Ownership, Accountability and Control		A possibility under this Option A would be to have one or more industry-appointed Board members, either in addition to or instead of independent Board members. A further possibility would be to also include one or more Board members directly representing consumers. A review of DCC's objectives specified in its licence. New licence conditions placing obligations for improved customer engagement, and for better visibility of planned developments and projected costs.	Elexon supports consumer and independent representation on the DCC Board. However, the choice and appointment of the actual representatives within those categories should be the decision of the Board itself.
Incentives		Stakeholders have suggested that a move towards an *ex-ante* approach (where costs are agreed before they are incurred), for some or all areas of DCC's activity, should be considered. There would continue to be a need to undertake delivery of major changes and special projects whose costs are more uncertain than the costs of ongoing core services. Given their inherent uncertainty, it may be appropriate to introduce a hybrid regime, combining *ex-post* and *ex-ante* approaches to relevant parts of DCC's business.	We agree with a move to an ex-ante approach, which will give greater visibility to the stakeholders and allow for better planning of their own costs. There also may be merit in considering a number of ring-fenced financial incentives under Option A, which would incentivise behaviours and activities to ensure identified issues are addressed and resolved promptly. These could, for example, include a Stakeholder Engagement Incentive, Cost Control Incentive and Vendor Management

			Incentive. The size of these incentives should be proportionate to the value delivered from cost savings via better behaviour.
Funding		Funding for DCC's core services would continue to be primarily through charges on its users. Given the operational model of contracting out for most of the services DCC needs, relatively little capital would be required. In certain circumstances it may be appropriate for DCC's shareholder(s) to inject equity, or for DCC to issue corporate debt with appropriate guarantees provided by the parent company.	We agree with Ofgem's position on the future funding of DCC.
Operational Model		Current operational model requiring DCC to primarily procure services from External Service Providers (with a discretion afforded to DCC Board to decide on in-house provision of certain services subject limitations imposed by the licence) would continue. Compelling DCC to conduct an open tendering process would remain a means of ensuring that the costs of providing these services were reasonable and transparent. While changes to give DCC customers better transparency of business plans and projected costs could provide some improvement over the current arrangements; however, these changes would be sufficient to move away from the current operational model towards a model where DCC provides most services in house.	Elexon agrees that DCC services need to be delivered flexibly, considering new developments in technology and IT services, through a range of third-party providers and in-house capabilities. As noted above, best practice in third party contract management should be rigorously applied.

In addition to the above, we believe the low level of business risk associated with the monopoly nature of the DCC service (after the licence is granted), needs to be appropriately recognised in the allowed return. As a comparison, under the RIIO-ED2 price control regulatory framework the allowed returns for the electricity distributors are in the range of 3.9%, compared with the DCC adjusted costs margin of 13.8%[1].

Question 4: With regard to Option B, how effective do you think a non-profit-making, stakeholder-controlled or independent DCC Board would be in providing the quality and cost of service that DCC customers require, and managing DCC effectively?

As outlined in our response to the Call for evidence: Review of the regulatory arrangements for the Data Communications Company in March 2021, we strongly believe that a stakeholder-controlled or an independent DCC Board will be an improvement over the present way of governing DCC and will be critical in managing DCC effectively, leading to improvements in quality of services and driving down costs as much as practically possible.

We believe irrespective of the option (A or B) chosen as a preferred one, it will be important to ensure that the DCC Board Directors follow their duties to the DCC and that they are independent of their employing organisation when carrying out those duties. It should also be the case that funders/users should have representation on the Board.

The profit making aspect should be considered separately. As discussed above, if the preference is towards retaining the present model with some improvements, in our view, it will be important to cap the profit DCC can generate at a comparable level to other entities operating as natural monopolies and price controlled by Ofgem (for example, electricity distribution companies as highlighted in Q3).

We would like to outline below our main thoughts on the benefits of the NFP (not for profit) model that we discussed in our March 2021 response. Elexon operates as an NFP entity currently owned by National Grid ESO (with future ownership under consultation, given the transition of NGESO to a Future System Operator), funded directly by the electricity generators and suppliers and other market participants based on their market share, with an independent Chair and Board.

The members of the Board do not represent their employer or a particular constituency and can be removed by a vote of industry (subject to de minimis thresholds etc.) at an annual meeting. This gives BSC Parties an annual opportunity to determine the Board composition. Similarly, the budget is drawn up and approved by the Board, and then goes out to industry and the Panel for consultation, with industry having the ability to remove the Directors annually, if they take issue with the budget and the Directors responsible for setting it.

The BSC establishes the BSC Panel, which is made up of industry members appointed by industry vote for their expertise (and who are not representatives of their employer), plus other non-industry experts such as academics, who make recommendations to the Regulator about proposed changes to the BSC rules based on their own experience. One of the proposals under the ongoing Energy Code Review is to move decision making from code panels to code managers and to disband code panels. As noted in our response to the Energy Code Review consultation, we believe that the value of the expertise offered by panels such as the BSC Panel, as well as the committees that operate under the panels, should not be underestimated and it will be important to maintain the breadth and depth of input that the BSC Panel provides due to its composition and impartiality.

We believe that the NFP model delivers reliable, cost effective and efficient services to BSC Parties and the LCCC (in our EMRS capacity). Our carefully designed governance structure gives us independence from any specific subset of industry parties, with appropriate checks and balances in place. This independence allows us to support and enable market change and

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[1] 1 https://www.smartdcc.co.uk/media/hqoh2pyt/annual-report-2022.pdf
RIIO-ED2 Final Determinations Overview document.pdf

innovation without prejudice. We believe this structure enables us to generate and preserve value over the longer term by:

- Engaging with stakeholders in developing our strategic objectives and ensuring that our stakeholders continue to support those objectives through a customer centric approach to all aspects of our governance and changes;
- Allowing Elexon to be accountable to its customers, with customers having the power to remove both Board and panel members and materially change and influence Elexon's operation and activities, through multiple channels of scrutiny. This helps align incentives of delivery of required services with customer expectations;
- Allows for a focus on costs, efficiency and quality of service, by virtue of stakeholder control. There is no profit incentive, so the focus is on balancing these three critical proponents to deliver a high quality service at lower cost and more efficiently;
- Investing in technology to continue to provide best in class services and be responsive to the market and BSC Parties' needs;
- Enabling innovative new products and services, which challenge the current market structure, such as the introduction of Virtual Lead Parties into the Balancing Mechanism to provide greater market access for challenger business models such as local demand flexibility;
- Enabling a better understanding of the skills needed to perform in a rapidly changing energy market through the right balance between flexibility and the robust, predictable service delivery for which Elexon is recognised; and
- Maintaining our focus on knowledge sharing and transfer through impartial services to all market participants.

We remain of the view that independence and having the right incentives in place should be priority areas for consideration for the next DCC licence period. It means independence in decision making from any subset of the industry and from other stakeholders, which in turn requires the absence of single company control via shareholding or director appointments. The right incentives will mean that the delivery of the service for the funding parties is not distorted through the profit motive of shareholders, who know they have access to funders that do not have choice not to fund.

However, we recommend the NFP model proposed under Option B for DCC could be revised by:

- There needs to be a process in place, which means Directors can meet their statutory responsibilities and liaise with Ofgem should any potential conflicts with the law arise.
- There should be a mechanism in the contract to prevent Directors acting in the interest of their employer companies.

Where services are provided on a NFP basis, it is important that levels of transparency are high in order to promote confidence amongst the paying users and industry generally. For example, we publish our Business Plan every year and encourage all BSC Parties and the BSC Panel to comment on our strategy and detailed budget. Throughout the year we provide monthly forecasts of our expenditure.

For the reasons described above, we consider that a NFP business model is the right fit for the provision of central, monopoly services.

Question 5: Do you have any views on the details of Options A and B?

We have outlined our views on the details of Option A in our answer to Q3. We have the following considerations of note with regards to Option B:

OPTION B

Category	Category Description	Elexon's View
Ownership, Accountability and Control	Under Option B, the Board would represent the interests of the stakeholders directly (i.e. a 'stakeholder-controlled Board'), rather than relying on a price control to reflect those interests indirectly through incentives on DCC's shareholders.	In the past several years, DCC's annual budget of £450-600m has been the largest among all central bodies, representing ~50% of the total annual sum that the industry spends on gas and electricity central systems and codes, including NGESO's budget. In fact, NGESO budget, which is half of DCC's is subject to the rigorous regulatory framework and price control regime. Furthermore, under the Energy Code Review and licensing of the code managers, there is emerging thinking on what the licence should contain. Among priority areas to consider are Budgets and Incentives and any links to revenue. Industry should be able directly to control the largest expenditure in the central services space (DCC) that is proportionate and comparable with other budget control mechanisms for central systems and services.
Incentives	Arrangements under Option B would not require any explicit financial incentives on the organisation to drive quality of service. Incentive structures of complex operations can be difficult to design and imperfections can have unintended consequences. Under Option B, it is expected that the DCC Board would be able to respond to the needs of DCC users through the accountability route, thus removing reliance on an incentive structure. This also addresses the challenge of incentivising an asset light organisation like DCC.	We support this – We agree that no financial incentives are needed under Option B, as robust user accountability negates the need for an incentive structure.
Funding	As a not-for-profit business, no expectation of DCC's owner or owners to inject equity. Nevertheless, suitable indemnities could be provided by DCC users under the SEC and/or REC, as is the case under other codes, which would enable DCC to borrow any capital necessary to support the business (and to do so at low cost). In principle, there might also be the potential to raise risk capital for	We support this proposal.

	specific ring-fenced operations on a project finance basis.	
Operational Model	In the absence of a profit motive, DCC would be expected to focus on quality of service and value for money. This could allow for relaxation of certain restrictions placed on DCC's operational model and enable the DCC Board to take decisions, on a case-by-case basis, whether to undertake activities in-house or to competitively procure them from external service providers. However, the current operational model would not be substantially changed.	We are supportive of this; however, would suggest a range of more robust checks and balances on management of supplier contracts to ensure value from procured parties and lowest cost to the consumer.

Question 6: What are your views on the options identified and the associated trade-offs for a possible licence extension?

It appears that a licence extension is inevitable as the remaining time on the current licence is simply not enough to put in place the required new licence regime even for relatively minor changes considered under Option A. We agree with Ofgem's assessment that there is hardly an ideal transition period in the next 10+ years given the industry changes that are already in motion and planned, and considering the DCC service contracts' staggered end dates.

In the case of Option A (Licence Retender to successor Licensee): if this were chosen as the preferred way forward, we believe that phasing in elements of the future framework within the extension period to achieve potential incremental benefits to the current regime should be regarded as a priority.

In the case of Option B (Alternative Regulatory Framework): if this were preferred, we agree with Ofgem's assessment that a three-year licence extension could be necessary in order to allow enough time to develop the details of a new framework. We believe that Ofgem may need to consider verifiable existing best practice in the sector and apply those frameworks that have been tried and tested and known to deliver the desired outcomes. This may shorten the new regulatory framework development process.

Since both options require a licence extension to ensure a new framework is implemented robustly and properly, Option B does not necessarily translate into a longer reform period, which may be an initial perception given that is a more fundamental reform.

Question 8: In your view, which of the considerations we have identified for the transition period are the key dependencies and why? Are there any other dependencies that should be considered?

The DCC review must be planned in the context of other ongoing Ofgem/government-led projects and industry change with a number of parallel changes to consider as the transition period approach is defined. We agree that the following dependencies identified in the consultation are critical considerations for the transition period:

- Changes in BEIS's role in the SMIP and the transition to enduring governance arrangements
- Energy Code Reform and any upcoming changes to the Smart Energy Code (SEC) and Retail Energy Code (REC)
- The procurement landscape of DCC's contracts, with some key contracts due to expire over 2025-2031
- DCC's ongoing programmes, including Network Evolution

However, we also recommend that Ofgem consider that Market-wide Half-hourly Settlement (MHHS) is a critical dependency for the transition period as a smooth handover is critical given the DCC's central role in MHHS. The focus should therefore be on a change of DCC ownership, whilst ensuring continuity of people, processes and systems, to ensure there is no knowledge or skills lag for enabling the delivery of MHHS alongside the Smart Meter Rollout.

Question 11: Should the future framework permit DCC to carry out any services additional to its Core Mandatory Business? What are your views on the concepts of 'mandated services', 'ancillary services' and 'additional services to users'?

Elexon believes that DCC should be able to carry out any services additional to its Core Mandatory Business, as long as there are appropriate checks and balances, such as the evaluation of risk in relation to delivery given the finite resources of a central services body.

For example, Elexon delivers such 'additional' services such as the settlement of CfD and CM contracts through the legally separate EMRS body, and does so efficiently and robustly. EMRS bears its proportionate share of the total Elexon overheads such as office costs etc. Nearly £5.6m of such overheads have been borne by EMRS since 2015, meaning that without the EMR activities, BSC Parties would have had to bear an additional £5.6m over that period.

We would further note that Elexon, under the BSC, has clear conditions in respect of any additional services. We would highlight the four conditions that are required to be met by Elexon, if the BSC services are to be extended:

- BSC Parties should benefit from any diversification,
- the arrangements should not place disproportionate risk on BSC Parties,
- standards of service under the BSC should be maintained, and
- Elexon's BSC role should not give it any undue competitive advantage in a contestable activity.

We think these examples of due diligence, parameters for extension of vires and service-level checks and balances are critical to any consideration of extending of DCC's mandate from core services.