

ELEXON LIMITED

Diversification and governance

Introduction

- 1 This report has been commissioned by the Office of Gas and Electricity Markets Authority ('Ofgem') to consider the implications of diversification by Elexon Limited ('Elexon'). It is understood that it is intended that this report will be posted on Ofgem's web-site to promote discussion about the relevant issues.
- 2 Elexon administers the Balancing and Settlement Code ('BSC') for Great Britain. In this role it is the Balancing and Settlement Code administrator ('BSCCo') established by the BSC. The existence of the BSC and BSCCo (as code administrator) are the product of a licence requirement on National Grid Electricity Transmission ('NGET'), which is the sole owner of Elexon.
- 3 Until recently, Elexon has done nothing other than being the BSCCo, and BSCCo is not presently permitted to diversify. It is important to note that although BSCCo is a registered company, in practice everything has been done through Elexon Limited and the distinction between the two companies has been immaterial.
- 4 Recently, Elexon Limited was permitted to establish and operate a reconciliation mechanism for the Warm Home Discount Scheme¹. NGET has been directed by the Secretary of State to make a number of enabling modifications to the BSC to enable this.
- 5 Elexon has brought forward plans to diversify, such that (for instance) it may be permitted to bid for other electricity-related services and in particular to bid for the role of the smart metering Data Communications Company ('DCC') in a competition being organised by the Department for Energy and Climate Change ('DECC').
- 6 Elexon has asked Ofgem to lead a project looking at the expansion of Elexon's vires and the implications for Elexon's corporate structure.

Background

- 7 The BSC came into being when the electricity trading arrangements in England and Wales were reformed in 2001, with Scotland following in 2005. The energy balancing aspect allows parties to make submissions to National Grid to buy or sell electricity from or to the market at close to real time in order to keep the system from moving too far out of phase. The settlement aspect relates to monitoring and metering the actual positions of generators and suppliers (and interconnectors) against their contracted positions and settling imbalances when actual delivery or off-take does not match contractual positions.
- 8 Elexon delivers the BSC, running the code on the electricity industry's behalf. The GB electricity industry relies on Elexon to procure and manage service contracts with third party agents (notably IT service providers). These agents run the settlement activities –

¹ The appointment of the service provider will be confirmed following completion of a tender exercise.

a critical function. Elexon also handles trading disputes, administers the BSC change process on behalf of the BSC Panel and enforces performance standards.

- 9 All major participants in the British electricity industry are signatories to the BSC. The BSC signatories are responsible for the funding of Elexon according to a complex formula that changes each signatory's funding percentage from time to time. There is a BSC Panel that has direct supervisory responsibility for ensuring that the BSC is implemented – the Panel's Chairman is appointed by Ofgem, and the Panel comprises 12 members representing various interests, including significant industry representation.
- 10 Although NGET is the sole shareholder in Elexon, NGET does not operate as a normal owner. The funding of Elexon is the sole responsibility of the BSC members, and NGET bears no liability in this respect. In practice NGET is a purely passive shareholder and Elexon is managed by its Board, two of whose non-executive members are industry members appointed from the BSC Panel, with the other two being independent appointments.

Context

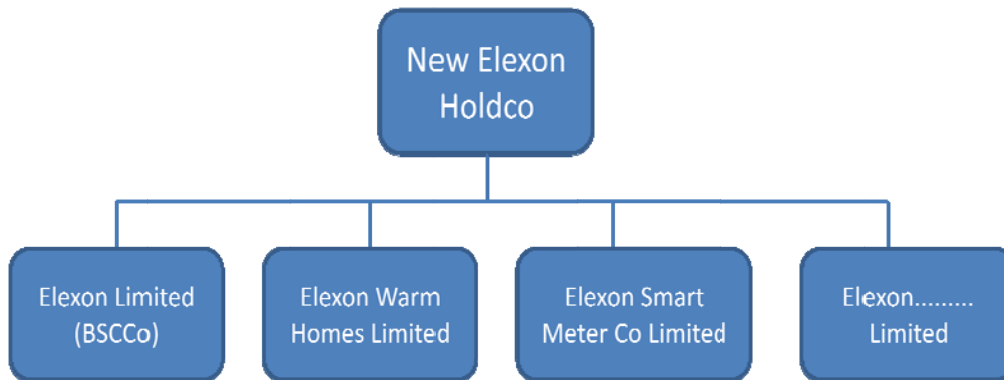
- 11 Elexon has made proposals to diversify, in particular to be freed up to bid for other British electricity-related contracts such as those being competitively tendered by DECC for the DCC.
- 12 Elexon's proposals are summarised in a document entitled "BSCCo Business Plan 2011-12", which was published in December 2010. Elexon has provided its view on industry responses to the Draft BSCCo Business Strategy in a document dated 10 February 2011. Elexon has also held a stakeholder event on 28th March 2011, and summarised its conclusions from that event. All these documents are available from Elexon's web-site.
- 13 Following the publication of the BSCCo Business Plan for 2011/12, E.on asked for a review of Elexon's governance and the funding arrangements for Elexon's new business opportunities, using the "Standing Issue" mechanism established by the BSC. This issue is known as Standing Issue 40 and the Terms of Reference were agreed by the Panel on 14th April 2011. There have been a number of subsequent meetings.
- 14 An independent Chairman has been appointed to review this issue (Mr Bharat Shah). Mr Shah has been consulted in the production of this draft report. The resolution of Standing Issue 40 is an independent process conducted in accordance with the BSC.

Elexon's proposals

- 15 Elexon has formulated its approach to diversification under three broad headings:
 - The case for diversification
 - Structural considerations arising, including financial structuring
 - Implementation considerationsThis appears to be a sensible framework, and is broadly followed by this report.

- 16 Elexon’s case for diversification is that it has programme management and other relevant skills that can usefully be deployed on other UK energy projects, particularly in relation to the DCC and Warm Home Initiative.
- 17 Structurally, Elexon acknowledges that the diversified projects should be served by entities that are part of an expanded Elexon group but separate from BSCCo. One possible visualisation of Elexon’s proposed structure is set out in simplified form in Diagram 1.

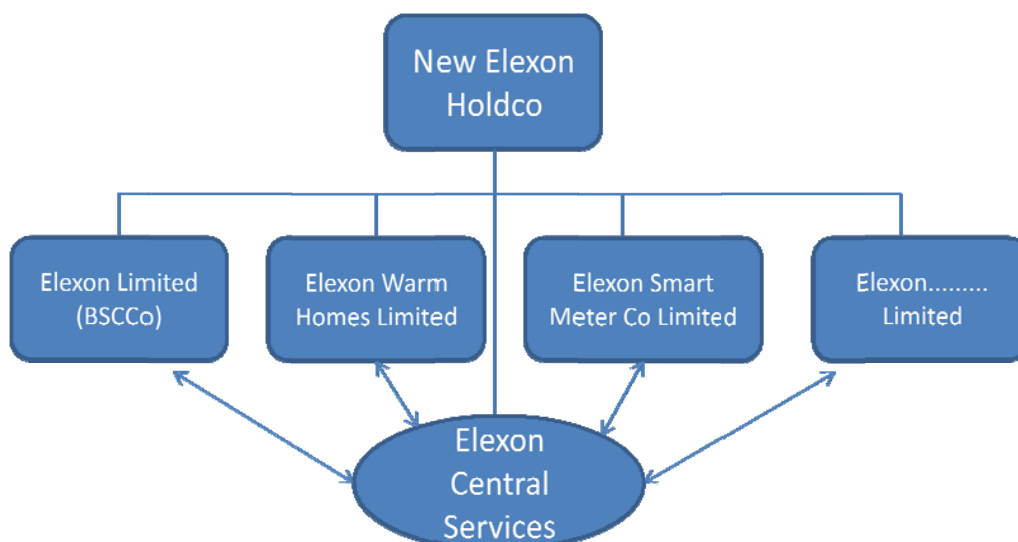
DIAGRAM 1: Simplified Elexon proposal for diversification of Elexon



(Source: Elexon Governance Proposals, Stakeholder Event, 28 March 2011)

- 18 Elexon’s model assumes that ownership of BSCCo transfers from NGET to a new Elexon Holding Company, and that the funding arrangements from BSC signatories would continue directly to BSCCo. The single box labelled “Elexon Limited” represents one or more single purpose companies, one for each new activity, analogous to the proposal to retain each main subsidiary (such as BSCCo) dedicated to its original purpose.
- 19 Implicit in the Elexon structure set out above is the notion that certain personnel and staff presently dedicated to BSCCo would in fact be available to serve the wider New Elexon Group, either in the new Holdco or across the new operating companies. Without this feature, the arguments in favour of sharing knowledge and experience are weakened, as is the possible benefit to be derived from more efficient use of resources over time.
- 20 It is therefore likely that the eventual New Elexon structure would look more like DIAGRAM 2 below, with some form of contractual relationship between BSCCo and a central services company (“Central Services Company”). The contractual relationship could entail the provision of the services of individuals from BSCCo to the rest of the group or – quite possibly – the provision of services from a central entity to BSCCo (and the other dedicated companies).

DIAGRAM 2: Simplified New Elexon structure showing shared central services company



- 21 Elexon has not yet defined the allocation of resources between BSCCo, New Elexon Holdco and (were it to exist) the Central Services Co. This would be a matter for more detailed consultation and negotiation (presumably with the BSC Panel among others).
- 22 Elexon has also not yet defined the contractual relationships that would need to exist, particularly between the Central Services Co and BSCCo, although it has identified that the BSC signatories would need significant protections in order to ensure the operational and financial security of BSCCo following this sort of corporate restructuring.
- 23 Elexon has proposed that BSC signatories should effectively fund the evolution of the diversification structure, including a £1m p.a. figure in the projections for 2012 and 2013 to cover the costs of developing a diversified business.
- 24 In a document dated 10 February 2011 entitled "Industry Response to Draft BSCCo Business Strategy" (references below are taken from the summary page entitled "Weight of opinion on Key themes), Elexon summarised the reaction of stakeholders to the proposals reported as follows:
- mixed views on Elexon's desire to diversify ("Vision and Growth" and also "Should Elexon be the DCC/SEC");
 - broadly negative views on the proposal for BSC parties to fund diversification ("Should BSC Parties fund bid activity")
 - mixed to negative views on Elexon's proposals to commercialise BSC assets ("Commercialising BSC assets")
 - mixed to positive views about the need to review Elexon's governance ("Governance reform")

- 25 Elexon has participated actively in discussions relevant to this review and have been open, helpful and responsive in explaining their business and their ambitions, and in exploring the issues associated with diversification.

Commentary on Elexon's proposals

- 26 This section reviews Elexon's proposals, broadly following the logical train suggested therein.

27 *Rationale for diversification by Elexon*

- It seems reasonable to believe that Elexon could usefully extend its activities in the UK, including:
 - administering the Warm Home Initiative
 - bidding for DCC role
 - other electricity related roles in the UK
- It is not clear whether Elexon would seek more general freedom in terms of:
 - non-energy UK offerings
 - international activities
- There may be sense in trying to learn in a step-by-step fashion, given the sensitivity to any problems arising. This would suggest staying in the UK energy space, at least initially, perhaps by a limitation within the Articles of New Elexon
- Bringing more competition to the provision of services in this market area would be welcome.
- It is credible that BSC's costs could be reduced over time by allowing Elexon to diversify and deploy its resources across a broader base. However there is likely to be an investive cost of establishing "*New Elexon*", and it is for debate how best this should be funded (see section 68 below).
- Elexon should gain learning experience from administering other programmes and this could result in general benefits for its customers
- This report has not looked in detail at Elexon's capability to implement or deliver diversified services. There is a slight paradox in that Elexon represents itself as a lean and efficient provider of services to BSC but also feels it has the capacity to diversify.
- A particular area that would need attention in this context is Elexon's Board. At present, this is set up to deliver the BSC rather than to run a diversified management services company

28 *Should diversification be undertaken within BSCCo?*

- There is common agreement that there is insufficient technical overlap and/or overlap of BSC member interest to justify extending the remit of the BSC administrator function to cover Elexon's likely areas of diversification.

- This implies that the diversified activities need to be carried out by a company that has a relationship with BSCCo but is separate
- The structure proposed by Elexon achieves a degree of separation, while making BSCCo a wholly owned subsidiary of the new Elexon group.
- The separation implied by diversification raises the central question in this whole debate, which is whether Elexon is primarily the service receiver (i.e. the BSCCo which requires services in order to fulfil its duties) or the service provider (i.e. a management services company providing services under contract).
- Under Elexon's proposed structure, there would need to be an allocation of existing staff into the different entities (New Elexon Holdco, any Central Services Co, BSCCo) and a contractual structure between the three of them by which BSCCo could fulfil its remit.
- Recognition of this point is crucial to the analysis that follows. In terms of terminology for the rest of this document, this distinction is recognised by using the following definitions:
 - BSCCo - the Code administrator, whether or not owned by Elexon
 - Elexon or new Elexon – the diversified management services group, whether or not it owns BSCCo
 - Central Services Company – a subsidiary or division of New Elexon providing services to BSCCo and possibly others.

29 ***What protections are necessary for BSCCo?***

- In any diversified scenario for Elexon, the operations and finances of BSCCo need to be safeguarded.
- This implies that BSCCo needs to:
 - own whatever resources are necessary for it to fulfil its functions;
 - be able to secure under contract other relevant services. If such a contract cannot be satisfactorily established, then it would suggest that diversification by Elexon is not, after all, feasible.
- In order to accomplish the split of resources envisaged, it is necessary to understand in more detail the functions of BSCCo and New Elexon and how it is proposed to allocate resources, including human resources, within the new structure.
- Elexon has not provided any detail about this in any of its documents (or indeed in my interviews with them). This is an important exercise which Elexon needs to address, if their preferred structure is to be adopted.
- In order to pursue the analysis of Elexon's preferred structure, some pro forma assumptions about the resources involved have been made. This report assumes that there are three key areas to be considered, viz:
 - Human resources;
 - Systems/data;
 - Finances.

Human resources

- Elexon has not provided a detailed breakdown of its human resources. This report assumes that the human resource in BSCCo can be classified into four broad functions:
 - Management and administration;
 - Strategic – dealing with BSC policy issues;
 - Processing BSC modifications;
 - Overseeing third party contracts, including the important contracts with IT service providers.
- In terms of management and administration it is assumed that BSCCo will require an independent Board of Directors (with industry representation as at present). This Board would presumably be tasked with delivering the BSC Administrator function and acting in an important intermediary role between New Elexon and the BSC members (and indeed other BSC stakeholders).
- In terms of strategic resource, it is assumed that BSCCo would need to retain some specialist strategic resource to guide and shape all strategy with regard to the evolution of the BSC and the delivery of the BSC role. It would be difficult to sub-contract this function in its entirety to New Elexon/Central Services Company, since any contractual arrangements with, and service delivery by, New Elexon would need to be within the scope of this strategic function.
- In terms of processing BSC modifications and managing the IT contracts, there seems no obvious reason why this should not be outsourced to New Elexon/Central Services Company, provided a suitable contract can be devised.

Systems/data

- It is understood that the systems that are the subject of the IT contracts are generally owned and operated by the relevant contractor. As such “sharing” those systems or accessing their benefit for New Elexon’s diversified activities would need to be done on a basis that was effectively at arm’s length from BSCCo. There seems no reason why New Elexon and the IT contractors should not be free to enter into such negotiations, provided that the BSC administration systems and their operation were not in any way jeopardised by the new agreement. This would be a matter for the Board of BSCCo to satisfy itself about.
- The protection of data has two principal aspects in this context - ensuring that the data itself does not risk being corrupted by any diversified activity; and that the confidentiality of the data was not inappropriately compromised. This is another matter that the Board of BSCCo would need to satisfy itself about.

Finances

- There are four main aspects to the impact of diversification on BSCCo’s finances:
 - Creditworthiness: ensuring that diversification does not entail undue financial risk for BSCCo (which would also be a major concern for other contractors with BSCCo);
 - Continuity: New Elexon’s service delivery should not be put at risk if New Elexon gets into financial trouble;

- Independence: BSCCo should not be financing the diversified activities of Elexon;
- Return – what benefit can BSCCo expect to see in terms of lower costs and/or improved quality of service following Elexon’s diversification?

Each of these is now considered in turn:

- *Creditworthiness*

It is clearly envisaged that New Elexon may enter into other service agreements with third parties, notably DECC with regard to DCC and WHI. It is difficult to see how these diversified activities can be de-risked to the extent that the creditworthiness of BSCCo (as a subsidiary of New Elexon in a normal corporate structure) ran no risk of being impaired.

It is therefore implicit in Elexon’s proposed structure that BSCCo will need to be the subject of some enhanced financial protection to ensure that it cannot be put at financial risk if New Elexon runs into difficulties for any reason.

Such protections are, of course, a feature of the present DNO (and many other) arrangements, with the relevant conditions being embedded in the relevant Distribution Licences. Since no licence is envisaged by Elexon’s proposals for BSCCo, some equivalent arrangements would need to be put in place to protect BSCCo’s financial position. It should not prove impossible to do this, even if the specific route to do so has not yet been mapped out.

This is likely to be a crucial issue both for the BSC participants (who will want to limit their financial exposure to BSC) and – particularly, the other BSCCo contractors, such as the IT contractors.

- *Continuity*

A separate risk arising from a diversified Elexon falling into financial difficulties is the risk to the continuity of the provision of the services themselves by Elexon. This risk can be minimised by setting stiff penalties for failure to perform in New Elexon’s contract, although it should be noted that other parties wishing to contract with Elexon may wish similar arrangements, which could in turn increase financial risk.

The traditional remedy to address this (well-known) issue is to retain within BSCCo sufficient resource to run a minimum acceptable service level while alternative arrangements are made. What this resource constitutes is clearly a matter for discussion between New Elexon and the BSC users. This issue highlights very clearly the potential conflicts of interest that arise if New Elexon is also the owner of BSCCo;

- *Independence*

It is clearly inappropriate for BSCCo to finance the diversified activities of Elexon. There are two principal reasons for this:

- It is no business of BSCCo (which is ultimately funded by consumers through BSC members in a carefully considered formula) to fund non BSC related activities, even if there is some general sector overlap. If Elexon’s diversified

activities should be done outside BSCCo (see above) they should also be funded outside BSCCo;

- Funding by BSCCo raises the potential for undue cross-subsidy, which could in turn mean that BSCCo had an unfair cost of capital advantage in any competition for its diversified services.

It is consistent with a desire to diversify by BSCCo that it should find third party funding to finance that diversification. This is a reasonable test of independence and a good discipline on New Elexon, which should strengthen its governance and business case.

There is no reason why BSC members should not also be funders of New Elexon, but this should be done at arm's length, not through the BSC mechanism and not as a general levy on all BSC members.

It is noted that BSCCo's business plan published by Elexon includes a grant of moneys from BSC members to explore diversification. It would be appropriate for this money to be repaid to BSC members (and credited to customers) as and when Elexon raises new capital for its new activities.

It also follows from this that Elexon's "not for distribution" policy may come into question from those providing the capital for New Elexon.

- *Return*

Ultimately there is little interest for BSC counterparties to facilitate diversification by Elexon unless there is some return to BSC members in the form of lower cost and/or improved quality of service.

Elexon raises this issue in general terms in advertising the benefits of its proposed diversification, but has not provided any concrete evidence that such benefits will accrue – indeed this would be difficult in the absence of knowing the terms of any diversified contracts that New Elexon might win.

30 **What structures could achieve the necessary protections for BSCCo?**

- It follows from the discussion above that a diversified Elexon owning BSCCo would need to propose:
 - What resources were intended to remain within BSCCo;
 - What resources would transfer to other New Elexon companies (presumably including TUPE and associated discussions with staff who were not staying in BSCCo;
 - A suitable contractual framework to govern the relationships between New Elexon Holdco, Central Services Co and BSCCo;
 - Suitable arrangements for a financial ring-fence for BSCCo, so as to meet the approval of the funders (BSC counterparties) and service providers;
 - What policies it proposes to adopt (which may need to be reflected in the articles of Association of New Elexon) to reduce the risk of interruption to the continuity of service;
 - What arrangements it proposes for the Board composition of New Elexon Holdco and BSCCo.

- These proposals go to the heart of several vital issues associated with the proposed diversification of Elexon:
 - What resources does BSC really need?
 - What sort of contract is appropriate – does it imply competition at some future date?
 - What sort of contract ensures that BSCCo has access to adequate resources and that service continuity is optimised?
 - What form should the financial ring-fence take and by what mechanism is it enforced if BSCCo has no licence as such? Could the BSC itself be amended to require this of the BSCCo?
 - What is the proper representation on the Boards of New Elexon Holdco and BSCCo?
- It should be obvious that new Elexon needs a counterparty with which to negotiate these proposals. It is not the purpose or remit of this report to dictate the answers to the questions. In particular the first three issues are necessarily the debating ground between BSC users and Elexon – and it seems obvious from this that the counterparty needs to be a representative group of BSC members, with the debate monitored and facilitated by an appropriate independent authority such as Ofgem. In any case Ofgem has an important locus in those debates as an independent defender of customers' interests.
- It follows from this that BSCCo needs a Board that is dedicated to the implementation and development of the BSC and that New Elexon (as a contracting party) should not be represented on that Board. Equally New Elexon needs its own independent Board appropriate to its new status and ambitions.
- The independence of BSCCo's Board under this structure raises interesting questions as to how that independence is enforced. These questions have been satisfactorily resolved in the past (most notably in the case of National Grid between privatisation and its own floatation, when it was owned by the regional distribution companies but had an independent board at the operating (licence-holder) level, with the power to enforce its own business plan, once approved).
- None of the foregoing suggests that Elexon's desire to diversify cannot be achieved using the structure that it has proposed, but it is clear that to implement it successfully will take a much greater degree of negotiation than is apparent from the present documentation relating to it.

31 Before assessing whether any other structures are worth considering besides the one proposed by Elexon, and the implementation issues associated with Elexon's structure and any others deemed worthy of consideration, it is probably worth pausing on two other issues that arise from Elexon's proposed structure, namely:

- Elexon's "not for distribution" proposal; and
- NGT's present ownership of the BSC administrator.

Elexon's "not for distribution" proposal

32 Elexon's "not for distribution" proposal is well intentioned and reflects its aim that any "profits" from its operations should be reinvested for the benefit of its clients. However, it is open to question on various fronts:

- Equity shareholders are not the only stakeholder in the business for whom distributions are important – management have a direct interest through pay and bonuses;
- In a potentially competitive arena, it would be concerning if the not-for distribution concept was in practice a form of cross-subsidy that reduced true competition
- Many would argue that the shareholders of new Elexon would want a return on their investment (assuming that the argument in favour of independent funding was accepted);
- Others would argue that the presence of shareholders expecting returns puts a form of continual pressure on efficiency and innovation that is complementary to the incentives created by a long-term contract.

33 None of the foregoing constitutes a knockout argument against the not-for distribution model, but they do urge caution when considering this aspect of Elexon's proposals, and the need for whatever is eventually implemented to be financially coherent.

The ownership of the BSC administrator

34 NGET's ownership of BSCCo is largely symbolic, arising from the origins of the BSC in NGET's licence and doubtless from a historic perception that NGT had a pivotal role in the industry that somehow fitted well with the provision of a critical central service.

35 In practice NGET's ownership carries no financial liability whatsoever. The financial liability resides entirely with the BSC signatories, whose individual liabilities to fund the BSC administrator change from time to time in accordance with a complex formula.

36 Although the BSC signatories are *en masse* the natural shareholders of BSCCo, it is impractical for them to be ordinary equity owners, given their shifting funding percentages and also the risk that a few bigger companies could own a "majority" of the BSC administrator to the detriment of the combined interests of the smaller companies.

37 NGET's ownership is therefore quite a neat way of resolving this issue. NGET is not an inappropriate shareholder, and their ownership permits the complex funding arrangements and governance arrangements surrounding the BSC to operate without the distraction of equity shareholdings.

38 This review has highlighted some of the issues associated with Elexon assuming ownership of BSCCo. In the event that such an ownership structure was not agreeable, continued ownership by NGET under the present arrangements would seem to be appropriate. Not disturbing these arrangements may also have some benefits in terms of implementation (see below). In particular, although NGET carries no formal financial responsibility for BSCCo, it is a natural and credible party to be the service provider of last resort.

Alternative structures

39 While Elexon's proposed ownership structure can probably be made to work, it is worth looking whether other structures could achieve similar effects without some of the drawbacks associated with Elexon's proposed structure as outlined above.

40 It is clear that a key issue is about the nature of BSCCo itself and its ownership. It is also clear that Elexon's proposed diversification almost certainly necessitates a contractual

split between BSCCo (in any ownership) and the rest of Elexon, particularly the parts that are intended to provide (or receive) shared services under contract.

- 41 Once it is accepted that BSCCo's Board needs a significant degree of independence and that such a contractual structure has to exist, it seems appropriate to look at other examples and see what lessons can be learnt from them and whether they can be applied to the BSC administrator.
- 42 One thought that underlies this study is that the Elexon proposals entail Elexon changing and thus inevitably BSCCo changing. An obvious question is whether there are structures that allow Elexon to change without entailing such fundamental changes to BSCCo.
- 43 The key features of BSCCo that are worth trying to preserve include:
- its dedication to meeting the BSC challenge;
 - its delicate balance of ownership and representation through the BSC Panel and the Board structure;
 - the financial security of BSCCo; and possibly
 - it's not for profit ethos.
- 44 It is noteworthy that Elexon recognises many of these issues in framing its own proposals. The question is whether therefore they can be more naturally achieved under another structure.

The outsourcing route

- 45 Although there are many variant structures that could be considered, the two fundamental issues in play are:
- The nature of the contractual relationship between new Elexon and BSCCo; and
 - The ownership/control of BSCCo.
- 46 As noted above, the identity between Elexon and BSCCo that presently exists means that the issue of contracting does not arise – Elexon simply is the BSCCo. As that situation changes as a necessary result of Elexon's diversification, a contractual interface is needed – and as a result the nature of that contractual interface needs to be considered.
- 47 A contract has little force unless it can be rescinded in the event of poor performance or inability to perform. It is also a drawback if a contract cannot be market tested from time to time. It therefore appears to be an inevitable consequence of Elexon diversifying that the contract with BSCCo will become more like a normal commercial contract and that BSCCo needs to retain sufficient resource to manage that contract and the consequences of its failure (however remote that risk may be).
- 48 One question with Elexon's proposed ownership of BSCCo in a diversified world is whether there is a sufficient degree of separation between service receiver (BSC administrator) and service provider (Elexon). In practice, the BSC Panel would have to become the monitor of Elexon/BSCCo's performance, but with limited representation on the board of BSCCo.
- 49 A stronger model might be to retain a truly independent BSCCo as the BSC administrator and to establish a new contractual relationship with a diversified Elexon, with the latter having no ownership interest in the body with which it was contracting.

50 This is the classic outsourced model. There are many instances of its operation in many different sectors, including the UK electricity sector. One particularly relevant example is MRASCo and Gemserv.

MRASCo/Gemserv

51 MRASCo is the Master Registration Agreement service company, which is tasked with supporting the processes for the registration of a change of electricity supplier in the GB retail market. Gemserv is the company tasked with servicing MRASCo's obligation.

52 Gemserv was established separately from MRASCo in recognition that the work in support of the MRA could be beneficially applied into other markets for the mutual benefit of all parties.

53 Gemserv is a completely separate legal entity from MRASCo and the provisions of the services as set out in the MRA are the subject of a Services Agreement between Gemserv and MRASCo. Any alteration to the Services Agreement requires the unanimous approval of the MRA Executive Committee and this arrangement ensures that electricity services are protected.

54 There are clear parallels here with the Elexon/BSCCo situation. Much of the rhetoric around Elexon's wish to diversify is consistent with what is said about Gemserv's creation. The need for a contractual and governance structure to protect MRASCo's interests is also relevant.

55 Gemserv has successfully diversified, in the sense that it provides services to other UK parties than MRASCo, and also overseas. It has been independent from MRASCo for 7 years, which can be considered to provide a reasonable track record of assessment for the purposes of this analysis.

56 The MRASCo/Gemserv example shows that outsourcing to an independent entity can be successful while preserving the ethos and focus of the "mother" company, in this case MRASCo.

57 This is of course just one example among many. Outsourcing is a frequent phenomenon, particularly where the interests of the public and private sectors interact. One other relevant example is the Private Infrastructure Development Group (PIDG) which has outsourced all of its operations. A Department for International Development report recently found PIDG to be among the most effective vehicles for delivery of aid, particularly compared with "in-house" providers.

58 One advantage of the outsourcing route is that it permits BSCCo to remain as a truly independent entity, focused on its sole objective.

59 Another advantage is that it allows new Elexon to focus on becoming a market leader in the provision of outsourced solutions, with a Board dedicated to that objective and untrammelled by the constraints of trying to match that objective with the objectives of BSCCo.

60 In summary, detachment from BSCCo in this type of structure is both the price of freedom for new Elexon and also its reward.

How would outsourced model for BSCCo work?

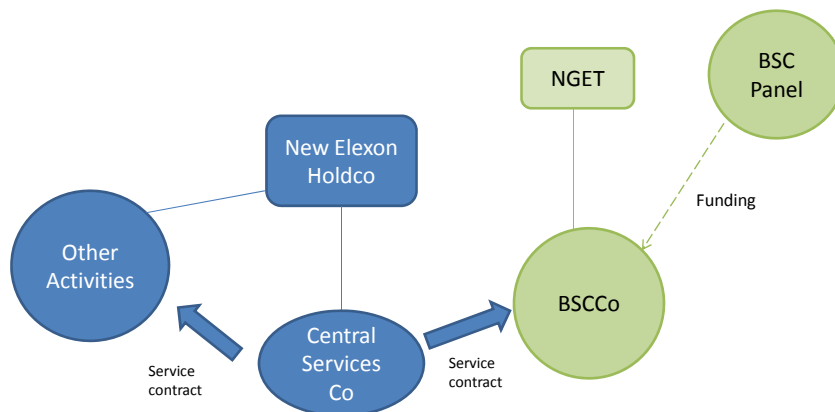
61 If Elexon were to be an outsourced provider of services to BSCCo as an independent entity, the following issues need to be resolved:

- The terms of the contract between BSCCo and Elexon;
- Resourcing of BSCCo;
- The ownership of BSCCo;
- Board representation of BSCCo;
- The financing of new Elexon;
- The Board/governance of new Elexon.

62 It is noteworthy that all of these issues need to be resolved anyway under Elexon's proposed structure for BSCCo. In addition to this, there are a significant number of issues associated with the implementation of this structure. These are considered, alongside the equivalent issues for Elexon's proposed structure in the sections on implementation below.

63 Before looking at each of the issues listed in paragraph 58, it is probably helpful to look at a possible diagram of this structure as an aid to analysis:

DIAGRAM 3 Simplified diagram of outsourced structure



64 The terms of the contract between BSCCo and Elexon:

- It is assumed that BSCCo will retain staff to manage the new Elexon contract and to provide some internal strategic direction, as a minimum. There is no apparent reason why other functions, such as processing BSC modifications and managing the IT contracts could not be outsourced. Indeed, if a reasonable level of services cannot be outsourced, then arguably this structure is unsustainable and not worth the effort of establishing.
- Defining the service level delivery in such a contract should not be too challenging given that this is at least in part a reflection of the service levels that BSC members expect of Elexon today.
- A crucial issue is the tenor of any contract and its contestability. There is probably an argument for a relatively long initial contract period, to give Elexon certainty of operations while building its diversified business and to ensure a reasonable period of transitional continuity for the BSC administrator.
- It is not for this report to recommend the detailed terms of any such contract – this should be a matter for negotiation between Elexon and appropriate representatives of the new BSCCo, overseen by the appropriate authorities. (NB this needs to be done under Elexon's structure too).

65 Resourcing of BSCCo:

- Again it is probably for BSC Panel to determine what resourcing BSCCo really needs. Manifestly it needs its own Board (although the majority of existing Board members may be appropriate (see below) and a small executive team, whose primary task would be strategic oversight of the BSC and management of Elexon's contract).
- One advantage of this structure is that very little else needs to be changed. The ownership would almost certainly remain as at present (see below), and the contracts with the IT providers and the funding arrangements would need no change.
- Other than (possibly) the permission for the BSC administrator to outsource the proposed function to New Elexon, it is not clear that the BSC itself or the statutes of the BSC administrator would need to be changed.

66 Ownership of BSCCo:

- As noted above, the BSC members fund the BSC administrator in amounts that vary from time to time according to a complex formula. It would be hard to replicate this in a shareholding structure – and there may be other arguments against allowing BSC members to be shareholders, given the different interests that are represented among BSC members.
- There seems no reason to change the existing arrangement whereby NGET remains as the symbolic shareholder of BSCCo.

67 Board representation of BSCCo:

- BSCCo's Board is presently constituted of Elexon members, Industry representatives and independent directors.
- It is not clear that Elexon should have the right to Board seats in any new outsourced structure – there are different philosophies about whether prime contractors should:
 - be included on Boards (with the view that they need to participate fully and need to be bound in to the overall objectives of the service receiver);
 - not be included on Boards (on the grounds that almost any discussion is affected by a conflict of interest on the part of the service provider).
- This is ultimately a matter for negotiation between Elexon and BSCCo representatives.

68 The Financing of new Elexon:

- There is no reason why the underlying cost of service provision by Elexon should rise as a result of this restructuring – indeed over time it should come down, as foreshadowed by Elexon in their present proposals.
- Depending on the contestability and terms of the service contract, however, there may be a premium payable associated with the risk inherent in the contract.
- As a result of this, the immediate cost to BSC of this proposal may be higher - at least initially – to which needs to be added some incremental cost associated with the need to create a new governance structure within BSCCo.
- As stated earlier, BSCCo should not be funding Elexon’s diversification programme – this should attract its own equity on its own recognisance. There is no objection to BSCCo members being investors in new Elexon, but that should be a matter of individual choice for each of them.

69 Governance of New Elexon

- It is clear that New Elexon will need its own Board (as it will under its own proposed structure). This should be distinct from the BSCCo Board, and there would clearly be no requirement for BSC members to be Board members of New Elexon.
- This is essentially a matter for New Elexon’s investors.

Interim summary of structures

- 70 There are only really two important structural considerations, namely whether BSCCo needs to retain in-house its full functionality and who should own BSCCo.
- 71 There appears to be no reason why BSCCo should not have some of its functions outsourced – after all this principle is already inherent in the outsourcing of its IT contracts.
- 72 The more critical issue is who should own BSCCo. Elexon’s proposal to own BSCCo can probably be made to work in practice, but with quite a lot of ring-fencing of BSCCo needed.
- 73 The outsourced structure takes the principle of separation to its logical conclusion, but involves more short term upheaval and probably more cost as well.
- 74 Before making a final assessment of the structures, it is necessary to look at the last critical component in the debate, namely implementation.

Regulatory oversight

- 75 During the course of this review, it has been appropriate to consider what level of regulatory oversight is applicable to BSCCo and what rights and duties Ofgem should have in respect of the developments envisaged in this review.
- 76 At present there is no obvious regulatory regime for the BSC Administrator. It is a function established in the BSC, which is in turn a creature of the requirement in NGET’s licence to create such a code.
- 77 BSC Administration is not a licensed function as such and therefore the ability of the regulatory authority to dictate the terms under which it operates, particularly in the areas

of continuity of operations, integrity of operations and minimum cost burden on customers are somewhat limited.

- 78 It could be argued that the functions demanded of the BSC Administrator are so crucial to the industry that the industry has sufficient incentive to make sure that these areas are properly covered without the need for additional regulatory intervention. Indeed this is how the system appears to have operated to date. Against this, the same argument could be made in respect of, for example, air traffic control, which does have its functions and costs regulated.
- 79 This issue appears to be something of a lacuna, even in the existing arrangements. It is arguably thrown into sharper relief if ownership of Elexon is transferred to a commercial body, such as New Elexon under the Elexon structure, since it would appear to be important for the regulator to have the ability to step in and/or transfer vital functions in the event of a failure of New Elexon. Ofgem has comparable rights in the event of the failure of other crucial parts of the industry, such as the supplier of last resort provisions for retail supply, and the special administration scheme for distribution network operators.
- 80 It is unusual to find a critical part of a regulated industry that is not itself directly regulated. Ofgem might wish to consult on whether a licence for the BSC Administrator was an appropriate protection for customers, even if the present structure of Elexon did not change, but particularly in the circumstances envisaged by the Elexon proposals.

Implementation

- 81 Implementation is important on a number of fronts, viz:
- Timing – Elexon needs to be able to bid for diversified activities and to be able to operate any successful bids;
 - Vires – Elexon needs the vires to diversify, which in turn may require changes to various constitutional documents including the BSC and Elexon’s articles;
 - Consents – in practice, BSC members and Elexon itself have to be happy with the new arrangements. Unwilling BSC members would prove a huge barrier to Elexon’s diversification aims – equally it is important that Elexon’s Board and employees feel enthusiastic about the proposed new structure to be adopted, otherwise it risks foundering at its birth, with potentially adverse consequences for the operation of the BSC in the meantime.

Timing

- 82 Timing is primarily driven by the timetables for the projects for which Elexon wishes to bid. In terms of the smart meter contract, DECC/Ofgem produced the following timetable in their joint response to consultation:

FIGURE 4: DECC/Ofgem Smart Meter Timetable

Baseline plan key milestones	
Draft technical specification complete	July 2011
EU notification period for the technical specification complete	Jan 2012
First tranche of regulatory obligations on suppliers comes into force, including: <ul style="list-style-type: none"> ▪ Mandated rollout completion date ▪ Installation code of practice 	Q2 2012
DCC licence application process commences	Q2 2012
'Smart' change of supplier arrangements become standard	Q4 2012
DCC licence awarded	Q4 2012
DCC service providers appointed	Q4 2012
Start of mass rollout	Q2 2014

Source: p39, Smart Metering Implementation Plan: Response to Prospectus March 2011

- 83 It will be noted that this timetable envisages the licence applications process commencing in Q2 2012, and the DCC licence being awarded in Q4 2012. It would seem logical to assume that Elexon needs to know by the time it bids for the DCC contract that diversification is capable of happening, and that implementation of the chosen structure can be safely effected before the DCC mandate is awarded and goes operational.
- 84 There is therefore an important distinction between the enabling of Elexon's diversification and its full implementation. In practice (assuming that the timetable set out above is adhered to), the principles of Elexon's diversification need to have been agreed by the middle of next year, sufficient for Elexon to be able to bid for the DCC role in the confidence that it would have the vires and resources to fulfil the contract, if awarded, from 2013 onwards.
- 85 It will immediately be apparent that a significant amount of negotiation needs to be had to make either of the two basic structures work according to this timetable. The Issue 40 Group is under way, but this will need to be reinforced by a real willingness on both sides to resolve structural and detailed negotiating issues. In practice this probably means that DECC and Ofgem will need to be proactive in their support of the project, encouraging resolution of issues and then facilitating the means by which vires can be granted for whatever is to be adopted.
- 86 The major components of the process that are going to affect timing are:
 - Negotiations between BSC and Elexon (including resolution of Issue 40);
 - Elexon's own reorganisation as a result, including the detailed negotiations with staff (incorporating 'TUPE'² where appropriate).
- 87 The negotiations between BSC and Elexon really require a decision in principle to be taken about the preferred structure going forward. A prerequisite of such negotiations is to establish the negotiating parties for each side and their terms of reference. This work clearly needs to start as soon as practical irrespective of the adopted structure.
- 88 Arrangements also need to be put in place for the smooth running of Elexon during these discussions – it will be self-defeating if the core business is in any way degraded during the progress of the negotiations.

² This refers to Transfer of Undertakings (Protection of Employment) law

- 89 The allocation of posts to the different bodies within the new structure has not really started. The posts need to be identified and then the process for filling them initiated.
- 90 This is likely to take a considerable time under either structure – although the process itself is likely to be substantially similar, since the resources required by BSCCo are likely to be similar under either structure, legal advice would need to be taken on whether there is any effective timing difference between them.
- 91 Elexon have stated that they believe that their structure would be quicker - and maybe easier - to implement because Elexon remains as the BSCCo. This is not obvious, however, and it may well be that retained ownership by NGET actually facilitates the legal timetable for the transfer of staff. As stated above, further legal advice is needed in this area.
- 92 Elexon has already brought on additional resource to help it with the negotiations. It would be helpful for BSC to identify and appoint its own team as soon as possible too. This is needed to negotiate terms for any diversified structure.

Vires and consents

- 93 The following analysis is a judgement based on the available information. It needs to be subjected to professional legal comment. Nevertheless, it should prove directionally useful
- 94 Table 1 shows a schematic of the consents required under each structure:

Issue	Elexon's proposed Structure	Outsourced structure	Comments
BSC members to approve overall "package", even if not BSC mods needed	Needed	Needed	As discussed passim in this document
BSC to be amended	Probably needed – to permit terms for BSC to be owned by a diversified group	May be needed – to permit outsourcing	
NGET to transfer ownership of Elexon	Needed	Not needed	Need to check transferability of shares. No reason to believe that NGET would be reluctant to relinquish its shareholding
Need to tender outsourced services (e.g. through OJEU ³ process)	May need to tender outsourced services	May need to tender outsourced services	Need for independent legal advice
TUPE/pensions	Probably required for staff transferring out of BSCCo into	Probably required for staff transferring out of BSCCo into	Need for independent legal advice

³ Official Journal of the European Union in which all tenders from the public (and in some cases Utilities) sector above a certain level must be published.

	new Exelon Group companies	new Exelon Group companies	
Licence for BSCCo?	May well be appropriate	May be appropriate	See discussion in sections 72-77

Comparison of Structures in terms of implementation

- 95 The table above suggests that both routes require a number of critical consents. It is not clear that either structure makes a significant difference to the substantive approvals needed by the BSC members; or to the process of allocating Exelon's employees to their new roles.
- 96 The requirement to set up new Boards for Exelon and, possibly, for BSCCo is unlikely to be a differentiating factor. BSCCo will effectively need an independent Board under Exelon's proposed structure.
- 97 The requirement for Exelon to raise new capital and find investors is equally common to both routes, if it is accepted that BSC should not fund Exelon's diversification. If BSC is allowed to provide such funding on a transitional basis (as is implied by Exelon's BSCCo business plan and subsequent documents), then this would make Exelon's proposed structure easier to implement.
- 98 Further consideration could be given – in this context – to whether there are transitional structures that could facilitate the transition for Exelon in terms of being in a position to bid for the DCC work but only implementing the structural changes over a transitional period.
- 99 The main issue would appear to be the speed at which the new contractual arrangements need to be put in place. In an ideal world the new contractual framework (under either structure) would be fully negotiated before Exelon submitted its binding bid into the DCC process. In practice this is unlikely to occur: a more reasonable target would be to achieve reasonably detailed heads of terms, blessed by Exelon and the BSC Panel, covering the most important issues in terms of the continuity of service, dedicated resource and funding issues.

Next steps

- 100 This review is purely advisory. It is designed to help interested parties think through the issues associated with Exelon's proposals to diversify. It is specifically commissioned by Ofgem in anticipation of Ofgem, at the request of Exelon, leading a project looking to expand Exelon's vires and change their corporate structure.
- 101 Irrespective of Ofgem's role, it is clear that Exelon and BSC representatives need to agree a framework for adopting a structure and setting up the negotiations needed to get Exelon into a position to be able to bid for the DCC role (and possibly others) with confidence.
- 102 Several of the people interviewed in framing this draft report said that leadership from Ofgem and DECC would be helpful in driving the project forward.
- 103 It is understood that this review, once completed, will be published on Ofgem's web-site. It is hoped that this will provide a helpful stimulus to the next stage of the process, including the resolution of the Issue 40 agenda.

CONCLUSIONS AND RECOMMENDATIONS

- A. Elexon should be permitted to explore diversification on a timetable that allows it to bid for relevant other UK work, notably the DCC role.
- B. The diversified activities should take place outside the BSCCo and the BSCCo should remain dedicated to ensuring continuity of a good BSC service.
- C. Elexon needs to establish one or more new group companies to undertake diversified activities and to provide services to BSCCo.
- D. The Boards of New Elexon and BSCCo need to be populated appropriately for their respective roles and interests, with an appropriate degree of independence for the BSCCo Board.
- E. BSC panel and Elexon should agree on those resources that are necessary to BSCCo in order to maintain its role, and which services can be outsourced to other parts of the New Elexon group.
- F. BSC Panel and Elexon should agree on their preferred ownership structure for BSCCo – with ownership either being transferred to Elexon, as Elexon proposes, or remaining with NGET.
- G. BSC Panel and Elexon need to agree an appropriate contractual structure to ensure continuity of service and financial robustness for BSCCo (under either route).
- H. BSC Panel and Elexon need to agree a clear path to implementation, including important staff issues (TUPE, pensions) such that Elexon can bid for outsourced work with reasonable certainty and implement any contracts awarded according to the relevant timetable.
- I. The absence of a licence for the BSC Administrator function may be a lacuna in the present arrangements. Ofgem is encouraged to consult on this issue, particularly if it is proposed to transfer the ownership of BSCCo to a commercial company.
- J. Ofgem and DECC have an important role to play in pushing forward these discussions and providing such enabling support as may be necessary to implement the conclusions.

APPENDIX 1

Background to this draft report

Documents

The following documents were relevant to the production of this draft report:

Document	Source
BSC	BSC
BSCCo Business Plan 2011-12	Elexon
Industry response to draft BSCCo Business Strategy	Elexon
Summary of ELEXON Stakeholder Event	Elexon
Terms of reference for this review	Ofgem

Interviewees

My thanks to those who were kind enough to speak to me in the course of producing this report, sometimes more than once. They included:

Person	Organisation
Mark Bygraves	Elexon
David Osborne	Elexon
Alon Carmel	DECC
Richard Leyland	DECC
Nigel Nash	Ofgem
Jonathan Dixon	Ofgem
Stuart Cook	Ofgem
Nigel Cornwall	BSC Panel
Barbara Vest	BSC Panel
Bharat Shah	Independent Chairman, Issue 40
Peter Bolitho	E.on
Alex Travell	MRA Executive Committee