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Dear Rachel

Open Letter Consultation: Potential Expansion of the role of Elexon

Thank you for the opportunity to contribute to your deliberations on the potential expansion of the role of Elexon. Our members have followed the Elexon proposal to expand its remit closely since the issue was raised by the Elexon management in the 2010/2011 Elexon Business Plan, via participation in the Balancing and Settlement Panel and its Issue 40 group established to investigate potential models should expansion be proven to be acceptable by a majority of code signatories and attendance at your 8th December 2011 round table discussion on the proposals.

There are a number of issues which we would like to comment upon regarding the question of the appropriateness of Elexon moving from its current low risk, industry critical role as prescribed by the Balancing and Settlement Code under a not for profit/not for loss organisation to one which undertakes a wider and more risky for profit/for loss organisation.

Potential role expansion

As stated above, Elexon currently operates a low risk, industry critical role as prescribed by the Energy Act 2000 which required the creation of the Balancing and Settlement Code, the Balancing and Settlement Code Company and Elexon as a not for profit/not for loss organisation. For generators it is paramount that the critical functions currently undertaken by Elexon on our behalf with regard to balancing and settlement are protected at the level expected by the Energy Act. Early clarification of how Elexon intends to protect core services in a manner that is transparent to the industry, with or without a change to its current role, would be helpful. The current Elexon Business Strategy for 2011/2012 is light on detail in this regard and with Elexon Board discussions being totally opaque to those stakeholders funding its activities; it is extremely difficult to judge how successful Elexon will be in this regard.

Members have seen a continued reduction in costs and improvements in the standard of service provided by Elexon, and as such are happy to retain the status quo for Elexon and BSCCo. To date there has been no call, or in fact justification provided, to overhaul the remit of the company. Indeed, with the potential for change as a result of the DECC Electricity Market Reform (EMR) initiative and the prospect of an Ofgem-led Significant Code Review of Electricity Cashout arrangements, members believe that undertaking a business transformation project, which can only result in a significant diversion of management attention, would be an additional and unnecessary burden during 2012 and 2013. In order to change that view members would require a clear business case to pursue new business opportunities together with a demonstration that the right safeguards will be put in place to protect and ring fence the core.

If central balancing and settlement processes require amendment in order to respond to the SMART program, then such demand-led change will be pursued under the current governance regime in an orderly and efficient manner. Widening Elexon's vires at this point in time is not fundamental to the future success of SMART. Generator signatories to the Balancing and Settlement Code see little benefit in an extension to the Elexon vires; however, any consequential deterioration of the essential services that Elexon currently provides could have a significant effect on generators' businesses.

Models under consideration

Whilst members trust that the views of generators, as significant contributors to the Elexon budget, are being given adequate consideration, we acknowledge that consideration has been given for Ofgem (or even DECC) to impose a change to the current 'not for profit' Elexon remit. We are aware of two models under consideration - Contract vs. Subsidiary - but would like to understand why it has been deemed inappropriate to continue with the tried and tested organic growth route delivered by the incremental change model. This approach has ensured the successful delivery of NETA, BETTA and, within recent months, settlement processes established in support of the Warm Homes initiative; this approach remains the preferred option for a change to Elexon's remit, if such change is proven necessary.

Members have assessed the limited information available on the two models that Ofgem is currently considering. There continues to be a significant lack of information surrounding: the ring-fencing and delivery mechanism for the current core balancing and settlement service; the expected membership and remit of any subsidiary businesses; funding and the extent of liabilities; and the preferred vires and governance model for each of the models. At this early stage, some members believe that the 'Contract' model may provide the most robust protection for code signatories but only if supported by the right safeguards. Other members remain unconvinced that any model should be pursued until additional information has been made available for assessment. We note that the scant information available at present would not be sufficient should we be building a case for expansion within our own businesses.

Elexon Bidding for the future role of DCC

Finally, we provide views on the potential for Elexon to bid for the future role of DCC. We understand that the Department of Energy and Climate Change is keen to see Elexon enter a bid for this work, rather than be required to undertake a service provider role with respect to enhancing the data and services it currently controls as part of its role as administrator/guardian of the Balancing and Settlement Code. We assume that DECC has adopted this view in order to increase competition for the DCC role but an explanation of its rationale and details of its risk assessment that led to that conclusion would be valuable. In particular the DECC risk assessment needs to consider the increased risk on our members who would be substantially exposed financially should problems arise which impact on Elexon's ability to perform the critical BSC functions or, in the case of failure, result in the cessation of the GB electricity market trading and settlement, for a prolonged period of time.

Has consideration been given to providing Elexon with a temporary derogation in order that it might participate in the bidding process, provided that a majority of code signatory funders support such a move? In addition it would be of interest to understand why DECC has decided that the tried and tested route successfully utilised in the past for the introduction of NETA and BETTA and provided for within the Electricity Act 2000 is now no longer appropriate.

If you would like to discuss any of these comments further please contact Barbara Vest, Head of Electricity Trading on 07736 107 020.

Yours sincerely

David Porter
Chief Executive
Association of Electricity Producers
By Email

AEP Response to Consultation Questions

1. Do you consider that we have set the right conditions for a potential expansion of Elexon's role?

   Yes we agree that the four conditions are proportionate and appropriate.

   Condition 1: BSC Parties should not face higher costs; our members do not wish to fund any future activity which delivers no benefit to their business. Indeed, should any expansion be ultimately agreed into areas such as provision of a DCC service, there may in fact be a case for compensation payments to BSC Signatories where a new venture seeks to utilise any BSCCo or Elexon resource or asset. All the current assets have been paid for by BSC Parties. If these assets are to be transferred via the subsidiary model then the transfer must be done on the basis of a 'fair market value' whereby new 'Elexon' pays this value back at the time the assets are transferred. Failure to do so would not only be inequitable to BSC Parties but also anti-competitive as it would amount to a subsidy from the BSC to the new 'Elexon' allowing significant opportunity to under bid in, say, the DCC tender.

   We note that Elexon Management has on many occasions stated that the decision regarding whether to go ahead with submission of a bid to undertake the DCC role has yet to be made. We would recommend that if Ofgem thought that the business case had been proven to change the vires in order to submit a DCC bid and Elexon were subsequently unsuccessful then the baseline arrangements should be reinstated and future growth be handled as today i.e. organically.

   We should appreciate an explanation of how BSC Signatories will be informed of any potential future activities related to this and how they will be able to ensure that speculative spending, without their agreement, is minimised.

   Condition 2: The arrangements should not place more risk on BSC Parties; there are significant business risks whenever any expansion to the current baseline is undertaken. Undertaking the transition to BETTA and the recently introduced Warm Homes Scheme were no exception. In the proposed case uncapped diversification must impact the whole business. At a time when true organic growth can be expected anyway as the industry changes to reflect new legislation delivering Electricity Market Reform, coupled with a potential Significant Code Review of electricity cashout we are concerned that this unnecessary distraction, which would require additional expertise outwith the current skill set of Elexon, would be a step too far.

   Condition 3: Standard of service should be maintained; this is perhaps one of the areas of most concern given the recent exodus of expertise from within Elexon. There has been a reorganisation of roles and responsibilities which we believe needs time to 'bed in' in order to ensure that the new regime delivers the level of improving service that members expect and are paying for. The 2012/13

Business Plan does not fully explain how the core business would be adequately ring fenced, resourced and protected. We share your preliminary views around compliance and, in the case of failure, what appropriate sanctions could viably be imposed without undue impact on BSC Parties and ultimately consumers.

Condition 4: Elexon's BSC role should not give it any undue advantage in the DCC Competition; see our answer under ***Condition 1*** above.

2. Do you consider a contract or a subsidiary model would better meet our conditions?

We remain sceptical about whether a solid case for change has yet been proven given the impending changes required by EMR and SCR into electricity cashout arrangements. Considerably more detail is required in order to ensure that the business case is robust.

It is difficult to see any advantages being delivered via the subsidiary approach, which on the face of it appears to offer an uncontrollable opportunity to take this core service of Balancing and Settlement into any uncharted area.

From the limited information available within the 'Contract' model, our members have some support for the options around either (i) the 'leasing' approach (where all the current assets that BSC Parties have already paid for are retained by BSCCo and leased to 'new' Elexon) or (ii) the 'thick' approach, rather than the 'thin' approach. It appears that approaches (i) or (ii) may provide the lowest risk and maximum protection for BSC Parties when compared with the 'thin' contract approach, provided this is backed up by adequate and transparent additional safeguards.

For example, should a problem arise with the non-BSC aspects of Elexon's business in the future and this were to result in Elexon falling into administration then, with the leasing option, the (BSC) assets paid for by BSC Parties cannot be sold. The concern here is if they were sold, this could place the BSC in a highly vulnerable, if not fatal, position. Furthermore, with the leasing option, the ability for 'new' Elexon to reallocate or reprioritise those (BSC) assets to other more profitable (from Elexon's perspective) work; to the detriment of the BSC; would be prevented / impeded as the ownership of the assets would reside with BSCCo, not Elexon.

The leasing approach may provide an additional benefit in that it allows BSCCo to offer that lease to other service provider(s) who may be successful in other, similar, work such as the DECC tender for DCC. This may enhance competition in both the provision of services to BSCCo and also DCC. If these assets were to be transferred to Elexon (say via the 'Subsidiary' model) then this would not appear to be case.

3. **Do you consider that the role of the BSC Panel should change in response to a change in the role of Elexon?**

   The BSC Panel is constituted as prescribed by the Balancing and Settlement Code and as such should still deal with that business as normal. It is for Parties to consider, should any change to vires be agreed, whether provisions within the code need to be amended in response.

4. **Would the current arrangements for the BSCCo Board allow it to fulfil any additional responsibilities and mitigate any risks associated with the expansion of Elexon's role?**

   During development of this AEP response, Elexon published details of a proposed change (P281) to the BSC arrangements with regard to the future composition, role and responsibilities of the BSCCo Board. We shall watch development of that proposal with interest. The paramount consideration should be protection of the current essential Balancing and Settlement services required as a fundamental basic to the success of our members businesses.

5. **Do you consider that the existing role of NGET in the BSC, in particular its ownership of the BSCCo and licence obligations, should be reconsidered and in what way?**

   Yes, but in a way which would strengthen the bond. The lack of detail regarding consideration of any expected boundaries or limitations to the expansion of the new 'business' and our assessment of the existing baseline services plus whatever may emerge as a result of EMR and SCR on electricity cashout means that this 'business' could become 'too big to fail' and must therefore require the continued backstop provisions currently provided by NGET. Closer links to NGET and improved monitoring and reporting should be considered whatever is deemed an appropriate model going forward, even if we retain the status quo.

6. Do you consider that the BSC Board is appropriately constituted and resourced to deliver its enhanced role, including the negotiation of contracts?

As the new modification proposal (P281) dealing with the Board structure may not be progressed in line with your decision making on this issue then it would be appropriate to look to industry to provide the expertise to manage, on behalf of the Board, this complex process of contract negotiation. Membership of a special project team should be sought from BSC signatories, operating under a fully transparent process prescribed and agreed by code signatories.

However the tricky issue of funding of this exercise needs to be dealt with prior to the commencement of any further work on this matter. Should a majority of BSC signatories agree by special resolution to vary the proposed 2012/13 budget in order to fund this exercise, then appropriate provisions should be developed to ensure full repayment of any expenditure incurred and agreed within the proposed initial set up three year timeframe.

7. Do you consider that the BSC should be given a right of ‘step in’?

Yes the service provided for under the BSC is vital to the industry and consumers it would therefore be negligent not to require the licensee to ‘step in’.

8. What are your views on the best way to overcome the implementation challenges?

It is difficult to understand, under the current rules, what ‘defect’ any modification to the current baseline BSC any modification would seek to address. Early sight of any proposed modification(s) would be most welcome.

A clear understanding around the ownership of Intellectual Property Rights and company Assets is necessary at the earliest opportunity. It is the view of our members that all the existing IPR and company assets of both BSCCo and Elexon have been paid for by BSC Parties and therefore whilst they reside ‘in trust’ with the BSCCo and Elexon the ownership of these assets remains with BSC Parties who paid for them.

The most important aspect is to ensure ‘buy in’ from the majority of affected Parties. If BSC signatories, given access to the significant additional information we have outlined above, are supportive of the change the necessary resource will be found to expedite delivery of whatever change is deemed necessary.

Members do not believe that there is sufficient information on either approach to warrant sign-on to a specific business case at present, but, would be happy to provide detailed views on the questions below once further information has been published around provision of current core services, ring fencing, resource requirements, business structure, Board and Management roles and responsibilities, transparency, monitoring and reporting, the future role of NGET, etc.

Contract Model

9. Do you agree with our assessment that a contract could provide a relatively straightforward way of giving BSC parties confidence that they are not being called upon to carry the costs of new activities?

10. If the contract model is adopted, do you consider it a viable option to create a contract on the basis of “as is” service levels and costs (+ margin to be negotiated) for a relatively short period with a requirement on the

BSC to retender after a period of x years? If so what period do you consider appropriate?

11. If the contract model is adopted, which assets, if any, do you consider should remain with the BSCCo or be transferred to the new Elexon?

12. If the contract model is adopted, what approach do you consider most suitable for ensuring that incentives exist for performance, that service levels are sufficiently defined and secured, and that value for money achieved?

Subsidiary Model

13. Do you consider that in the event the subsidiary model is adopted, a ring fence would provide a suitable safeguard of BSC Parties interests? Specifically, what are your views on:

a. The BSC Panel's ability to effectively hold Elexon to account under the subsidiary model?

b. Whether enhancing NGET's licence to put new responsibilities on them in respect of any ring fence provision would be a suitable approach?

c. Whether it would be better to do this through a new licence which would make Ofgem responsible for enforcement?