Consumer Focus
Campaigning for a fair deal

6th January 2012

Rachel Fletcher
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Dear Rachel

Response to Open Letter Consultation: Potential expansion of the role of Elexon

We are grateful for the opportunity to respond to this consultation. The issue at hand has potentially important and material effects on consumers.

It is not immediately clear from the consultation document what the benefits of Elexon's expansion are either to BSC parties or to consumers, whichever of the two proposed models were to be put in place. If Elexon were to win a number of other contracts there would be savings due to efficiencies, but these could potentially be cancelled out by set-up costs of either model. In addition to this, the contract model could in fact turn out to be more expensive for BSC parties, due to the necessity for a 'premium' on the work to be done as performance incentive. The subsidiary option leaves a risk that the new Elexon HoldCo may prioritise for-profit work over non-profit work, unless there is a premium on this work in that model too.

We can see that an expansion of Elexon's role would benefit consumers and other parties if it were the case that the company would be the best providers of DCC services – and any other services it might bid for – to such an extent that consumers and parties would suffer detriment if current restrictions prevented Elexon from bidding for such contracts. However this case has not been made thus far.

In the absence of this case being made, it is also potentially of concern that public money may be spent in order to make an organisation able to bid for a piece of work when there could be other firms already existing which might perform the job equally as well.

Please see the appendix for answers to your specific questions.

This response is non-confidential and may be displayed on your website. If you have any questions regarding its content please contact me on 020 7799 8043.

Yours faithfully,

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Appendix 1:

Answers to specific questions

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

We believe that the conditions which have been set are the right conditions but that they may not be exhaustive, and in areas the language could be re-focused.

We would suggest that a further condition be added, namely that the arrangements should not pose a threat to continuity of service in the event that either Elexon HoldCo (under the subsidiary model) or New Elexon (under the contract model) encounters financial difficulties which result in the company being unable to provide services for a period of time or permanently.

All of the conditions are framed to mitigate negatives rather than deliver positives, for instance 'should not face higher costs', 'should not place more risk', 'should be maintained'. By implication, the status quo could meet all of these tests. This raises the question as to why public money should be spent to facilitate a change that leaves consumers no better off than simply making no change at all. We would be more comfortable with tests that are more positive, i.e. 'should reduce costs', 'should improve services' etc. The onus should be on Elexon to demonstrate that there is value to BSC Parties (and by extension, to consumers) in expanding its remit, not simply that things will not get worse.

We also suggest that Condition 4 should be broadened. The impending public tender for the DCC role has meant that attention has naturally focussed on considering what arrangements would allow Elexon to tender for that role. But both its draft business plan for 2012/13 and your consultation suggest that it could also bid for other activities in the future. It is therefore important for any arrangements to be future-proof. We suggest re-framing this Condition as 'Elexon's BSC role should not give it any undue advantage in competing for other contracts'.

It is unclear that either of the models wholly fulfils the conditions already set by Ofgem; this is discussed further in answers to subsequent questions.

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

Each of the models poses problems in meeting the conditions set out by Ofgem and the additional condition suggested above by Consumer Focus. It should also be noted that sticking with the status quo would meet all of the conditions set out by Ofgem.

Contract Model

It is not clear that the contract model would necessarily meet condition 1. Under the model, BSC services, which are currently provided on a non-profit basis, are to be provided on a basis which includes a profit margin. As the consultation document says, is possible that efficiency savings could be made under the model, which would offset these extra costs, as well as the costs of setting up this new model. However, the exact mechanism through which these savings might be made, particularly in the event that New Elexon does not attract investment or win contracts for other work which has synergy with BSC service provision, has not been made sufficiently clear. In addition, the consultation document suggests that under the contract model the BSCCo board would need to bring in extra resources in order

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to have sufficient expertise to secure value-for-money contracts; this would push the cost of this model up further.

In theory the contract model could increase incentives on Elexon to improve performance and reduce costs of BSC operations because it would face the risk that it could lose this role on periodic re-tender. However, the value of these incentives is likely to be diluted by other factors.As the incumbent service provider of a unique set of industry arrangements, Elexon would be likely to have a significant natural advantage over alternative providers that may limit the BSCCo Board's ability to negotiate a cheaper initial contract with it. In addition, the three year initial contract length you suggest is sufficiently short that the re-procurement process for the BSC role, with its associated costs, may start as early as the second year of the contract. We suggest that five years may be a more suitable minimum contract length in order to avoid incurring continuous re-procurement costs and the inclusion of risk premia in tender prices to reflect short contract duration.

The contract model as currently conceived does not necessarily guarantee condition 3 either. The reasons for this are discussed below in answer to Q10.

Subsidiary Model

It is not clear that this model guarantees condition 2 of the proposals, particularly with respect to financial risk. The need to create a 'fire wall' or ring fence around the finances of the part of the HoldCo providing BSC services is discussed both in the consultation document and in the Morse report, but neither report suggests how this might be done in a foolproof manner.

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

No strong opinions on this question

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?

No, please see answer to Q6

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, it should be reconsidered. NGET currently performs three different roles in relation to the BSC, and two of these could be quite problematic under the suggested new arrangements:

Firstly, NGET is subject to a 'best endeavours' licence obligation to put in place the BSC arrangements and to ensure that these arrangements comply with the (basic) requirements of them that are set out in its licence.

Secondly, where Ofgem decides that a modification to the code should be implemented, this takes the form of a direction to NGET under its licence. NGET then instructs Elexon to modify the BSC accordingly.

Thirdly, in extremis, Ofgem can direct NGET to step in and take over the implementation and/or assessment of modification proposals if Elexon is failing or is likely to fail in any material respect of the operation of those procedures.

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Under either of the new models, the first and third roles become problematic. This is because both of the new models envisage that equity holders in part, or all of the new family of Elexon company(ies) may not be NGET. In this context it would not be appropriate for NGET to be exposed to licence sanctions in relation to any part of the Elexon business that it does not own, because these would be beyond its reasonable control.

However, this poses the question, particularly under the subsidiary model, of who should be held accountable for these parts of the Elexon business. The following issues are relevant:

- Fining the BSCCo itself would be counter-productive because these costs would be passed on to code signatories, and indirectly to customers.
- Strong financial incentives (penalties) on the wider Elexon group may be undesirable if, as expected, its wider roles are in the area of critical national infrastructure: there is likely to be consumer detriment if the BSC or DCC arrangements collapsed.[1]
- Fining equity partners may not be possible if they are unlicensed.

Nonetheless, removing obligations on NGET and not replacing them with obligations of similar weight on the new family of Elexon companies and/or their equity partners may create a lack of incentive which is not in consumers' interests.

The second role, that of instructing the BSC to modify the BSC under Ofgem's direction, seems to add little value even at present, and could usefully be replaced by a mechanism through which Ofgem simply notifies Elexon directly that a modification should be made.

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

The consultation document suggests that the BSC board is not appropriately constituted and resourced to deliver effective negotiation of contracts. It is suggested on p8 that further resources of some sort should be provided to ensure that suitable contracts are negotiated.

In addition to currently relying on Elexon staff for support to sign-off contracts, the Board also currently relies on Elexon staff to prepare papers and conduct pieces of analysis for it, which under new arrangements could create a conflict of interest. This suggests even more that further resources may be needed.

Out of the options listed for extra resource of this sort, we would suggest that the recruitment of suitable staff may be most appropriate, since staff members may have a greater stake in negotiating a value-for-money contract than temporary consultants, and may have greater procurement-specific expertise than extra board members or BSSco directors. Staff may also be more cost effective in the long run, particularly if they are needed also for the preparation of papers and to conduct analysis, although it is also possible that a mixture of consultants and staff could be best value for money.

7. Do you consider that the BSC should be given a right of 'step in'?
Yes. However, it is unclear how any step-in, or the maintenance of systems and personnel who could provide the step-in, would be financed.

8. What are your views on the best way to overcome the implementation challenges?
No comment

[1] It should be noted that this problem is not Elexon-specific, and would be likely to affect any DCC provider.

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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?

Not necessarily, no. Presumably the contract to provide BSC services will be agreed at a set price at the beginning of the contract period. If for some reason provision of services turns out to be considerably cheaper than expected, or New Elexon is able to make greater efficiency savings, these savings would be kept within New Elexon. If New Elexon is fulfilling a number of other contracts at the time, then these savings from BSC service provision could in fact be used, quite reasonably, to carry the costs of new activities.

It would not be productive to counter this by writing the contract such that any unexpected savings had to be handed back to BSC parties, as this would take away any incentive for efficiency savings to be made, and therefore stop them from being made.

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?

No. It is not clear that a contract without any financial incentives, and with non-renewal as the only redress, is sufficient to guarantee high service levels. In order to keep costs down for BSC parties it is unlikely that the profit margins for the provision of BSC services will be very high. New Elexon could, therefore, find itself in a position in which other contracts are more profitable than the BSC services contract, meaning that it would make business sense to leave more resources for other, more profitable contracts. This would mean that a threat of non-renewal of the BSC contract would not be very threatening, meaning that there would be little incentive to keep service levels sufficiently high until the end of the contract period. Therefore it is suggested that financial incentives are included in the initial contract from the outset.

In addition, by definition a contract based on "as is" costs plus a margin to be negotiated will fail the first of your four tests – because BSC Parties (and by extension consumers) would face higher costs (than the status quo of "as is" costs plus no margin). If you wish to go down the contract route it would be more appropriate to create a contract based on "as is" service levels, lower costs and an undefined profit margin that is effectively capped by this lower cost figure. This would ensure that there are continuous incentives on the new company to seek out efficiencies to maximise profit, while ensuring that Parties/consumers face lower overall costs. Ultimately, these changes should not result in a boon for Elexon – consumer money is being spent to fund its and Ofgem's efforts to expand its scope; it is important that consumers see some return on this investment.

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?

No comments

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?

As discussed above, if the contract model is adopted it is important that the contract is managed from the outset in a way which offers sufficient incentive, including financial incentives, to Elexon as the contractor to deliver a high quality of service.

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?
The consultation itself suggests that the BSC Panel may well not be able effectively to hold Elexon to account under this model. While, under current governance, the Panel has oversight on the BSCCo annual strategy it has no direct oversight of its budget; these decisions are instead made by the BSCCo Board. The papers and discussions of the BSCCo Board are largely invisible to stakeholders – indeed, this lack of visibility has been repeatedly challenged by BSC Panel members. In addition, the BSC Panel, by definition, is concerned with BSC matters. Under current governance it would not have any oversight on the non-BSC businesses of Elexon. It would not be in a position to judge whether Elexon is appropriately allocating its resources between BSC and non-BSC businesses.

The creation of a clear set of Key Performance Indicators for the successor business, and effective firewalls between the funding and resources of its BSC and non-BSC businesses will be imperative if it is to be held to account.

b. Whether enhancing NGET's licence to put new responsibilities on them in respect of any ring fence provision would be a suitable approach?
As previously highlighted in relation to question 5, this approach would be highly problematic if NGET is not an equity owner in the new business – and at the moment it is by no means certain that it would be. It is difficult to answer this question in the abstract, but may become easier as more detail emerges on the structure and ownership of the new organisation.

c. Whether it would be better to do this through a new licence which would make Ofgem responsible for enforcement?
Again, there is too little certainty on the ownership or scope of the successor Elexon to make a judgement on enforcement matters. For example, parts of the business may be regulated by Ofgem (eg the BSC, and potentially the DCC if it is successful in tendering for that role), other parts may be legislated by DECC (eg its administration of the Warm Homes discount scheme) and still other parts may be neither (depending on how it chooses to grow the business). We do not rule out the possibility that a licence-backed approach could provide appropriate protections but it would be useful if you could provide further detail on how you would see this working in practice; in particular, the extent to which it could mitigate risks to the regulated businesses emerging from problems in the unregulated businesses.

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