Propagating new growth—the changing role of Elexon

In this *Energy Perspective* we consider issues around the potential expansion of the role of the Balancing and Settlement Code (BSC) administrator to take advantage of some of the opportunities offered by government reform programmes. Ofgem has just concluded a consultation on the subject (*ES307, p13, 28/11/11*) that considered the conditions under which this expansion could take place and set out its initial views on possible organisational structures.

Pot-bound

When the NETA market was implemented over a decade ago, governance arrangements for Elexon were set up with the sole aim of it administering the BSC. As the BSC Company (BSCCo), Elexon is not allowed under the Code to undertake any activity outside the Code (save for administering the reconciliation mechanism for the Warm Home Discount Scheme, which has been added by government fiat).

The current debate about Elexon's role has been triggered by the smart meter programme. The roll-out provides opportunities for Elexon to use its experience in complex settlement, data management and procurement and contract management in related areas. This activity was the one Ofgem focused on in its consultation, particularly the imminent competition to select the licensed Data and Communications Company (DCC). The DCC will manage and communicate the massive quantities of data from the operation of smart metering. However, the focus on the DCC distorts the debate, given the uncertainty over the associated risks it will bear. But a less constrained Elexon could take on other roles such as administrator of the smart energy code; it could also manage payments under the electricity market reform (EMR) proposals. So the debate should be seen in this wider context.

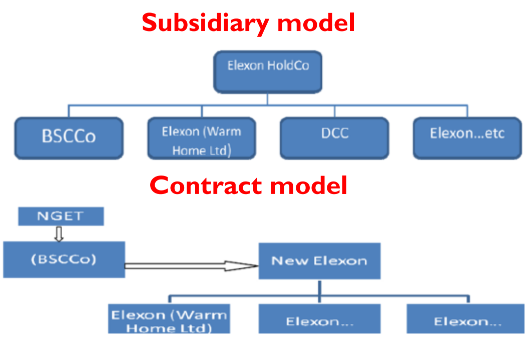
There should be real benefits to current BSC trading parties in Elexon leveraging off its core skills. New businesses should contribute to corporate overheads. Elexon's experience could help lower the risks implementing new processes for the wider good of the industry. Elexon may also do better running existing programmes, such as the levelisation process for FiTs. Organisationally diversification should also bring deeper and stronger business skills within the company. For these reasons Ofgem is right in principle to support a change to Elexon's vires.

Grafting

The key issue is, of course, how to prevent any role expansion exposing the existing BSC arrangements to additional costs or putting them at risk and ensuring that new activities are effectively ring-fenced. The current arrangements are clearly unworkable in any diversification scenario, as this would involve BSC parties assuming costs and risks for activities that are not related to the BSC. Because of this the industry has already expended a good deal of time and energy debating the options in the context of the business plan for 2011-12. It prompted Standing Issue 40 raised by E.ON UK on governance and funding arrangements for Elexon's new business opportunities. But given the BSC's foundation in National Grid Electricity Transmission's licence, Ofgem's active involvement is necessary to crystallise the debate and drive changes forward.

Ofgem has set out four conditions to safeguard the BSC arrangements: BSC parties should not be exposed to additional costs as a result of any new services; they should not suffer additional risk; standards of service should be maintained; and Elexon's BSC role should not give it any undue advantage in the DCC competition. These conditions are, of course, right and proper.

Alternative structures



Scaling and chipping

The next question is what kind of structure best meets these conditions. Two models have been considered: one which establishes the BSC Co as a subsidiary of a new Elexon holding company (the subsidiary model); and the other that would separate the BSC Co entirely from Elexon, with a contract between the BSC Co as the service procurer and Elexon as the service provider (the contract model) (*see diagram left*).

Ofgem's preference is for the contract model. In principle it says this should be a simpler approach. Once in place, this model should give certainty to BSC parties' funding responsibilities. Up for debate and negotiation is how much of the services should be retained in-house within BSCCo and what services should be the subject of the contract.

One element of the regulator's thinking that does not square, however, is its suggestion that any risk of the contract being less than optimum from BSC parties' perspective may be mitigated if it is for a relatively short period. Ofgem suggests an initial arrangement for two or three years, with a requirement on the BSCCo Board to re-tender. This approach simply would not give Elexon a bankable contract to mount any pitch for new business, and certainly not the DCC. Elexon has suggested that a 10 year contract would be nearer the mark, which does appear a shade long if it is awarded directly. We see merit in an initial period that runs to the end of smart meter roll-out in 2019.

Elexon in contrast prefers the subsidiary model. For this model to work, strong ring-fencing arrangements would be needed to give BSC parties assurance that they are not funding other activities in the group or being exposed to additional risk. Ofgem has suggested that many of the safeguards embodied in network operator licences may be appropriate, such as: restrictions on the disposals of assets; the requirement to have all necessary resources available to run the business; and restrictions on indebtedness and the types of payments and transfers that can be made to affiliates. But it has raised the concern that, without equity investment in either the subsidiary providing the BSC service or in the Elexon holding company, any penalties or sanctions are likely to be passed back to BSC parties.

Our view is that change to the vires is needed and that either model can be made to work. Under either model it is vital that specific rules exist to ensure that the core BSC business is properly supported and its functioning transparent, with no dilution of accountability for performance.

Potting on

Irrespective of the form of any new structure, the current BSC governance arrangements need reform. Whatever model is chosen BSCCo will be responsible for negotiating arms-length arrangements or contracts which effectively protect the interests of BSC parties. At the moment the BSCCo Board negotiates contracts with the support of Elexon staff, which could create a clear conflict of interest under the proposed new arrangements. In terms of the Board, the BSCCo chairman appoints two non-executive directors, with a further two non-executive directors selected from the BSC Panel membership with the chair appointed by Ofgem, and we have argued for some time that these arrangements require a refresh.

E.ON UK has just raised a BSC proposal (P281) to change this constitution because it thinks currently non industry non-executive directors and the chairman can carry Board decisions against the will of industry members. Accordingly the company has proposed a new board of four BSC parties (two suppliers and two generators, large and small in both cases) and an independently appointed chairman (ratified by Ofgem). New appointments should be based on voting for constituency candidates based on market shares. Under the proposal the Board could appoint up to three independent (non-voting) experts to offer support, for example on technical, procurement and financial issues. The proposal certainly has elements of merit, including breaking the artificial linkage between the Panel and the Board.

Hot housing

There is some urgency now. Ofgem wants to align its review process with the DECC schedule for invitations to be the DCC, due as early as Q2 this year. It considers that there will be sufficient time to progress the necessary modifications through normal change processes, with the greatest variable likely to be the development of a contract. The regulator expects to issue its decision on the way forward late this month or early February, with BSC modifications raised in February through to Authority decisions in Q2.

We have our doubts as to whether such a timetable can be delivered, not least because views within the industry are already polarised. But, even without the DCC dimension, it is essential that Elexon is permitted to pitch to develop and manage the smart meter code and support EMR work-streams. Because of the provenance of these programmes, which are key elements of government policy, the surest way forward could well be for the secretary of state to direct the necessary changes if it appears Ofgem's way forward cannot be delivered and promptly.