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FAO Rachel Fletcher
Smarter Grids and Governance, Distribution
Ofgem
9 Millbank
London
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6th January 2012

Dear Rachel,

Open letter consultation: Potential expansion of the role of Elexon

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax Power Limited also owns an electricity supply business, Haven Power Limited ("Haven"), which supplies business customers and provides an alternative route to market for some of Drax's power output.

Drax welcomes Ofgem's open letter regarding the potential for expansion to Elexon's role. Answers to the specific questions raised in the document can be found in Annex 1 to this letter. However, Drax would like to highlight a number of points.

Drax agrees that conditions 1, 2 and 3, as set out in the open letter, cover the key concerns of industry participants. To date, no detail has been provided on how appropriate protection (such as ring-fencing arrangements) would work. It should be noted that this is an issue for both the subsidiary and contract models, as each carries its own risks for BSC Parties. The key development priority for the models should be to minimise risk to core processes and to maintain the high standard of service that Elexon, in its current role as BSCCo, currently delivers.

Drax notes the clarification provided by Ofgem at the Stakeholder Event on 8th December 2011 that if, upon completion of the industry process, it should become clear that measures cannot be put in place to allow the expansion of Elexon's role and, *at the same time*, meet the conditions set out in Ofgem's open letter, the status quo arrangements shall prevail. Drax believes that this is a sensible approach.

Ofgem's recent announcement to engage with the industry to further evaluate appropriate BSCCo structures is both helpful and timely. Without the completion of this work, the resulting cost benefit analysis may be flawed and any decision on the appropriateness of Elexon expanding its role (regardless of the chosen company structure) could be ill-informed.

At present, Drax does not support any extension to Elexon's vires. The arguments to date have not been sufficiently strong to justify such change, particularly at a time when there is already an unprecedented level of reform progressing across the industry. This optional change may put the delivery of more urgent market reform at risk. In addition, there is concern that this issue may not attract an appropriate level of consideration as a consequence of time pressures.

If you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Stuart Cotten
Market Development Manager
Regulation and Policy

Annex 1: Drax response to the consultation questions

General

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

Yes, Drax believes conditions 1, 2 and 3 cover the key concerns of industry participants. The highest priority is to minimise any risk to the operation of the BSC and to maintain the high standard of service that ELEXON, as BSCCo, currently delivers.

It would seem sensible to ensure that key resources have a sufficient element of ring-fencing under each of the proposed models, including employees, IT systems, office equipment and BSC related data. Access to data is crucial for those parties that currently operate in the market and new entrants that wish to enter the market. Ensuring continued equivalent third party access to industry data will also ensure that Elexon does not have any undue advantage over its competitors, should Elexon be enabled to bid for new business.

In addition, the potential cost to BSC Parties of Elexon expanding its role must be considered, including any cost associated with funding bids for new work, the cost of the initial setup of the new business structure and the introduction of any competitive (for-profit) element to the BSC arrangements. For the latter element, a cost benefit exercise should consider the potential for efficiency savings in running the BSC and benefits of introducing a competitive process versus the initial setup costs of a service contract and the on-going costs associated with a periodic competitive tender process.

Drax does not consider there to be sufficient information available, as yet, on how core BSC services would be protected under either of the proposed models. Informing the industry of the full facts on the risks and benefits of the two models must be a priority prior to taking either option forward.

Drax welcomes Ofgem's clarification (provided at the recent Stakeholder Event) that if, upon completion of the industry process, it should become clear that measures cannot be put in place to allow Elexon to expand its role and *at the same time* meet the conditions set out in the Open Letter, the status quo arrangements shall prevail. This should help incentivise parties to provide greater information on how core BSC services would be protected under each of the proposed models.

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

Drax does not consider there to be sufficient information available, as yet, on how core BSC services would be protected under either of the proposed models. Until this information is made available, the industry will be unable to determine whether conditions 1, 2 and 3 could be met by either model.

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

How the role of the BSC Panel evolves will depend upon the chosen model and the resource available to the BSC Panel.

Under the subsidiary model, it would seem reasonable to assume that the role of the BSC Panel would not change substantially. Whilst the shareholder would be different (i.e. Elexon, rather than National Grid), the relationship with the shareholder would not necessarily change. The management team, and the day to day running, of BSCCo should be separate to that of Elexon. In other words, the role of the BSC Panel, and that of the BSCCo Board, should remain focused on purely BSC related business.

Under the contract model, it would seem reasonable to assume that the role of the BSCCo Board, and that of the BSC Panel, would be required to expand to ensure contracted services were delivered and agreed KPIs were met by the service provider. The BSC Panel and BSCCo Board would be required to take on greater responsibility for holding the service provider to account, should agreed standards not be met.

In addition, with regards to both models, the BSC Panel, BSCCo Board and / or Ofgem would require a framework that ensures appropriate action could be taken should service standards not be met. This requires a robust service contract (under the contract model) or BSC codification (under the subsidiary model) and may also require the introduction of a code administrator licence under the subsidiary model.

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. The BSCCo Board and Elexon Board are one and the same at present. Under both of the proposed models, the current Board structure (and membership) would not be appropriate to represent both the interests of the industry and Elexon. The Elexon Board should represent the interests of Elexon alone as a separate entity, whilst the composition of the BSCCo Board should be independent of Elexon. This is further considered in answer to Question 6.

Question 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?

There would appear to be no requirement to change NGET's role under the contract model. NGET could continue to own BSCCo on the same basis as it does today and could be required to 'step in' should the service provider experience financial difficulties.

Under the subsidiary model, there would be an inherent change to NGET's role, with the newly separated Elexon taking ownership of BSCCo. However, a 'step in' right would still be appropriate under this model to ensure the continued operation of the BSC.

For the avoidance of doubt, step in arrangements that ensure the continuity of BSC services in the event of financial distress must form part of any new arrangements, regardless of whether the role is performed by NGET or an alternative organisation.

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

No. The BSCCo Board and Elexon Board are one and the same at present. This would require addressing under both models.

Under the subsidiary model, it will be important to have greater representation from the industry on the BSCCo Board, with a truly independent Chairman (i.e. independent of both Elexon and the wider industry). Under the contract model, it is still unclear which entity would be the shareholder of BSCCo and whether the parent company would require representation (under the current model, this is not the case). However, it is clear that the Boards of both BSCCo and Elexon must be completely separate with no conflict of interest.

Given the potential changes to BSCCo and Elexon, the BSCCo Board may also benefit from additional industry expertise from a non-regulatory background, such as industry representation from an accounting or legal specialist. This could ensure greater scrutiny of the financial relationship between the two organisations, ensuring no cross-subsidy or undue influence occurs.

Finally, depending upon the chosen approach to the contract model (i.e. a 'thin' or 'thick' BSCCo), it is conceivable that BSCCo could consist of little more than the BSCCo Board and BSC Panel. As such, there may not be the required resource to enter into, and ensure an effective conclusion results from, the contract negotiation process. Access to the necessary resource may be costly and should be considered as part of the cost benefit analysis. Please see answer to Question 8.

Question 7: Do you consider that the BSC should be given a right of 'step in'?

The BSC must continue to operate regardless of the circumstances of its parent company (under the subsidiary model) or service provider (under the contract model). Given the importance of BSC continuity, a 'step-in' right is required to ensure the continued operation of the code. NGET may be the most suitable organisation to fulfil this role.

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

Drax does not consider there to be sufficient information available, as yet, on how core BSC services would be protected under either of the proposed models. Informing the industry of the full facts on the risks and benefits of the two models must be a priority prior to taking either option forward.

In the first instance, a workgroup should be established (consisting of industry parties, Elexon and National Grid) to work with Ofgem to develop more detailed models that include the appropriate ring-fencing and management structures. Without this information, the resultant cost benefit analysis may be flawed and any decision on the appropriateness of Elexon expanding its vires (regardless of the chosen company structure) could be ill-informed.

<u>Contract Model</u>

Question 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?

As would be the case with any model, it would depend upon the design of the company structures and the contract(s). There would need to be a complete separation of Elexon and BSCCo to create two distinct entities with separate funding lines, i.e. BSCCo funded by BSC Parties (as today) and Elexon funded by an alternative funding route. All bidding activity, including that associated with SMART activities, should then be pursued by Elexon, independent of BSC Party funding.

However, a key concern would remain over the use of current BSC resource under the contract model (e.g. the use of essential BSC staff for new business venture activities). This would be of particular concern if all current BSC related assets were transferred to the service provider. This could result in an indirect cost to BSC Parties and a degradation of service.

It would appear that one solution could be to ring-fence assets and employees so that they are only involved in BSC related work-streams (e.g. a 'Leasing Model'). This may be very difficult to control under the contract model, where both BSC services and new business activities may be managed at arms-length to any oversight body (such as the BSC Panel or BSCCo Board).

Question 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?

The key issues would be the potential risk to BSC Parties (from an operational, legal and financial perspective) and the potential for a degradation of service. There would need to be a reasonable level of benefit for any additional costs that result from the change, such as those costs resulting from setting up the new company structure, developing the contracts, the addition of a profit margin and future retendering processes. If a reasonable benefit cannot be established, it would be questionable why BSC Parties would wish to financially contribute to the change.

If a contract model were taken forward, it would seem appropriate to award Elexon the initial contract, to allow a period of stability under the new arrangements and to allow the company to develop its new income stream(s). An initial contract period of five years, prior to retender, would allow enough time for (a) Elexon to establish itself as an independent company and (b) allow the industry to ensure that the provisions of the service contract and the ring-fencing of the core BSC services were appropriately catered for.

A five year contract would strike a balance between the three year contract period suggested by Ofgem and the ten year contract period proposed by Elexon. Ten years of payments (i.e. profit margin) with no initial competition and no contract retender appears too long to provide a reasonable efficiency benefit to BSC Parties. In should be noted that NETA was only introduced a little over ten years ago.

However, it should be noted that there is insufficient information available, as yet, on how core BSC services would be protected under this model. This must be addressed prior to taking this option forward.

Question 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?

This will depend upon the ability to limit risk to BSC Parties, in terms of the ability to continue BSC operations should the service provider experience financial difficulty, the potential for a degradation of service and the potential for change to the cost base.

The risk to BSC operations could be much lower if all BSC assets were retained by BSCCo (people, IT infrastructure, office equipment, data, etc.), thereby effectively inviting companies to tender for a contract to manage a relatively complete BSCCo business. Under this approach, BSCCo could be run at arms-length to the successful bidder's existing business. This has the advantage of creating a ring-fence that is similar to that put forward under the subsidiary model (although arguably being simpler to administer and enforce contractual failures). However, it may limit the potential for efficiency gains as bidders may not be able to fully exploit business synergies. There may also be an inefficient duplication of assets by the two entities.

The other extreme would be to transfer all BSCCo assets to Elexon. Whilst this would allow Elexon to maximise resource efficiency between BSC operations and other business ventures, the level of protection offered to BSC Parties could be inadequate. This will ultimately depend upon the robustness of the service agreement and the ability of the BSCCo Board to enforce the contract in the event of service failures.

It should be noted that there is a strong belief within the industry that Elexon's / BSCCo's greatest asset is its people. If this asset were to be reallocated to new business areas, or BSC operations became more constrained as resource is spread too thinly, then this will result in a degradation of service. It is reasonable to expect that a new 'for-profit' Elexon would want to use its most talented people for the ventures that bring the highest return.

The most pragmatic solution would seem to be somewhere between the two extremes. However, a key element of any contract-based model must be to ensure that the level of expertise allocated to BSC-related work is maintained and protected (i.e. employees that currently work on core BSC operations continue in their present roles to maintain the high level of service that the industry has come to expect).

A workgroup should be established (consisting of industry parties, Elexon and National Grid) to work with Ofgem to develop detailed approaches to protecting core BSC operations under each of the models.

Question 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 suggested in the consultation document, it will be important to ensure performance criteria are enshrined in the service contract and that suitable actions can be taken by the BSCCo Board / Ofgem if the expected level of service is not met. The service criteria could be based upon the current BSC KPIs and the level of service that BSC Parties experience today.

One approach that would enable feedback to the service provider during the life of the contract would be to base the payment (profit) structure on an incentive regime. However, consideration should be given as to whether the current KPIs (as those used by Elexon today) would be suitable for an alternative business structure, i.e. would it be appropriate to adequately base payment, and provide an adequate quantitative assessment of achievement, on the KPIs used today?

In addition, it must be clear what services BSC Parties are paying for as part of the service contract. Would the service fee be "all-inclusive" for any work carried out by the service provider in administering the BSC or would additional services (specified or otherwise) attract additional costs?

Finally, Drax agrees that the threat of non-renewal of a contract may act as an incentive to meet contract service levels. However, the threat of contract termination may also be required due to the long-term nature of such service contracts. For example, if an inadequate service was provided in years one and two, it may be more beneficial to BSC Parties (and consumers) if the contract could be ended early (i.e. via termination rights) and retendered, rather than allowing the service provider to continue to take a profit for a further three years.

Subsidiary Model

Question 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?***

To date, no detail has been provided on how ring-fencing arrangements would work. It should be noted that this is an issue for both models as each carries its own risks for BSC Parties. This should be considered as a matter of urgency by Ofgem's proposed workgroup(s) and communicated to the wider industry. Until this work has been completed, it will be difficult for the industry to determine whether BSC Parties would be protected against an inappropriate level of risk.

Under the subsidiary model, it may be reasonable to expect the BSC Panel to take a fairly similar role as it does today. However, changes would be necessary to the composition of the BSCCo Board. It will be important to have greater representation from the industry on the Board, with a truly independent Chairman (i.e. independent of both Elexon and the wider industry).

As mentioned in answer to Question 6, the BSCCo Board may also benefit from industry expertise from a non-regulatory background, such as industry representation from an accounting or legal specialist. This could ensure greater scrutiny of the financial relationship between BSCCo and Elexon, ensuring no cross-subsidy or undue influence occurs.

With regards to responsibilities, it would not seem appropriate for NGET to act as an enforcer of ring-fencing provisions for the BSC. NGET is a party to the BSC and, under this model, would no longer be the BSCCo shareholder. NGET should not be fulfilling the role of a regulator. As such, it may be reasonable to create a new code administrator licence that allows Ofgem to take greater enforcement responsibilities over Elexon for its role in BSC operations.