

Rachel Fletcher
Ofgem
9 Millbank
London
SW1P 3GE

6 January 2012

Dear Rachel

Open letter consultation: Potential expansion of the role of Elexon

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, combined heat and power plants, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including both residential and business users.

EDF Energy welcomes the opportunity to respond to Ofgem's consultation on the potential expansion of the role of Elexon. The main points of our response are summarised below.

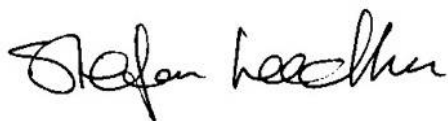
- EDF Energy agrees with Ofgem's proposed conditions on risk, costs, standards of service and competition. All of these need to be fully and clearly met before any expansion of Elexon's role is initiated.
- We do not support the expansion of Elexon's role unless appropriate and robust ring fencing arrangements are put in place to protect BSC parties from facing any increased risks or higher costs. Consequently, any role expansion plans by Elexon should be abandoned in the event that a third party investor is not obtained.
- The DCC role will be a licensed activity. It is therefore possible to introduce obligations within that licence that facilitate and reinforce the required operational and financial ring fencing of the DCC activity from any other activity performed by a subsidiary or ultimate controller of the licensee. This could be similar to that adopted within the Standard Distribution Licence in respect of financial ring fencing and separation of businesses requirements.
- Subject to the full achievement of the conditions, EDF Energy acknowledges that there may be potential advantages in Elexon being enabled to tender for the DCC role.
- There are also clear potential advantages in Elexon undertaking the new role of SEC Code Administrator. The risks for the SEC Code Administrator role would be lesser than for a DCC role, such that less rigorous ring-fencing or controls would be needed and may allow the proposal to be taken forward without an external investor.

- There has been a lack of clarity when questions have been asked about the proposed DCC venture. If Elexon's role is to be widened, clear and open answers are required. In particular, information on a clearly defined default point for abandonment of the venture in the event that a private backer is not found, is vital.
- For any role change to be acceptable, some governance reforms are vital: in particular, it is important to have a voting majority of BSC funding parties on the BSC Board, so that their interests in terms of extra costs and risks will be taken account of.
- It should be clearly recorded that all existing Elexon staff, assets, IPR and other rights are the property of BSCCo as constituted today. This would ensure that none are gifted for free to a new venture of which BSC Parties will not be a part to, or directly benefit from.

Our detailed response is set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact my colleague Paul Mott on 0203 126 2314, or myself.

I can confirm that this letter and its attachment may be published on the Ofgem website.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Stefan Leedham".

Stefan Leedham
Acting Head of Transmission and Trading Arrangements

Attachment

Open letter consultation: Potential expansion of the role of Elexon

EDF Energy's detailed response:

Risks and costs:

There are some significant issues relating to a possible DCC bid by Elexon that need clear resolution before any extension of Elexon's vires is permitted:

- EDF Energy agrees with the four conditions identified by Ofgem that would need to be met in a full and transparent manner before Elexon can undertake an expanded role.
- We as a BSC party are not willing to underwrite a bid by Elexon for the DCC role. There still remains significant uncertainty around the role, costs, rights and obligations that will be faced by the DCC. These risks and liabilities should in no way fall upon BSC parties either directly or indirectly. A prerequisite for any expanded role is that the current BSCCo arrangements are robustly ring fenced, both operationally and financially. Most importantly, this will require Elexon to obtain third party investment in order to underwrite its expanded role.
- Large I.T. or telecoms projects are associated with significant risks on costs and delivery. The potential for overspend and late delivery in respect of the DCC role could lead to penalties or remedial costs for the DCC. It is not appropriate for these risks to fall on BSC Parties; therefore, adequate arrangements will need to be put in place to ensure that any financial difficulties faced by Elexon in its expanded role do not fall on BSC parties or adversely impact the BSC arrangements. It is, of course, possible that some BSC Parties could independently volunteer to be among the sources of private equity that Elexon will require to underwrite this role.
- There has been a lack of clarity over certain matters in respect of Elexon's role expansion plans which has undermined confidence. It has not been possible to ascertain the answers to a number of questions raised by BSC parties. For instance, it is not clear what the level of funding for the DCC bid has been to date and what it is likely to be up to the point where a private equity backer will be involved and on what the threshold is (in terms of cumulative spend) at which BSC Parties can be sure to cease funding.
- Elexon has not acknowledged that any bid for the role of DCC would end in the event that a private equity backer is not found. It is not suitable for BSC Parties to underwrite a DCC tender bid by Elexon "by default", to cover the eventuality that no private investor is willing to take on all the risks and costs.
- For the change in vires to be acceptable, governance reforms will be required. In particular, it is very important to have a voting majority of BSC funding parties on the BSC Board, so that they have confidence that their interests in terms of extra costs and risks can be properly taken account of.

- There is a concern that Elexon carries out an industry-critical role as prescribed by the Balancing and Settlement Code. There is therefore a risk that an Elexon DCC enterprise would attract experienced staff from the core-BSC-services part of Elexon, especially if the remuneration packages are more attractive. There is also a risk of informal leakage of core BSC staff and management time and attention, if separate buildings are not used.

Potential benefits of Elexon being able to tender for the DCC role:

- Elexon has experience of managing significant contracts of a broadly comparable nature in the data and telecoms field. A typical issue that can arise with such contracts is that of a cheap initial tender, but with relatively high charges for any changes that are requested. This can occur even on fixed scales, since change requests of a minor nature could be allocated by the service provider to a "major change" charge-band. Elexon has experience of these issues from its management of BSC-related contracts in the past.
- Elexon has experience of handling data registration systems. The DCC will, from 2017, undertake management of customer data registration, although it will not do so for the first three years.
- Elexon's participation in the DCC tender may act to enhance competition for the DCC role encouraging enterprise and efficiency and potentially help to deliver lower prices and a higher quality of service.
- There is the potential for cost savings and more efficient use of assets given the synergies between the roles and processes that would be undertaken. However, it is important that the arrangements developed are not targeted to achieve such cost savings at the expense of weakening the required ring fencing arrangements of Elexon's activities. For example, we would like to see it clearly recorded that all Elexon staff, assets, IPR and other rights are currently the property of BSCCo as constituted today.
- Given the clear requirement for strict ring fencing, many perceived cost savings may not be achievable. Physical separation of the core BSCCo service from other Elexon activities may be required in order to ensure full financial and operational separation of activities. This would avoid the possibility of the DCC activity drawing on BSCCo assets (including staff) in a manner that is neither documented, nor paid for.
- In terms of synergies and sharing of core costs, we are in principle supportive of Elexon being able to undertake other new, non-BSC roles, such as that of the SEC Code Administrator (CA). Indeed, the role of SEC CA would appear to be a natural fit for Elexon, with strong synergies. In addition, BSC parties would face fewer risks in this case and physical separation would not necessarily be required. The role of SEC CA would, in particular, involve overseeing the performance of the DCC via support to the SEC Panel in this regard, or to a primary committee of the SEC a role similar to that currently undertaken by Elexon under the BSC. However, the DCC cannot be its own "policeman", so if Elexon tenders for the DCC role, the SEC CA role must be ruled out. This is a possible drawback of any DCC bid.

Associated Reforms and Governance

For the change in *vires* to be acceptable, it would appear that some governance reforms are required. In particular, it appears appropriate to have a voting majority of BSC funding parties on the BSC Board, so that there is confidence that the interests of those who fund Elexon and any additional extra costs and risks from a DCC Tender can be properly taken account of. We note that this is also consistent with the arrangements for Xoserve that Ofgem is proposing.

We also believe that it would be beneficial to confirm that all Elexon staff, assets, IPR and other rights are currently the property of BSCCo as constituted today. This would ensure that these are not transferred for free to a new venture of which BSC Parties will not be a part.

Provided appropriate ring fencing arrangements are put in place and 3rd party investment can be found we are not opposed in principle to Elexon's role being expanded. In such an event we would offer the following views on distinguishing the role of BSCCo from other Elexon activities:

- We currently do not have a strong view on whether organisational restructuring would best be undertaken via a subsidiary or contract model. Both options would involve developing appropriate contractual and governance arrangements in order to ensure the adopted option was workable for both BSCCo and Elexon.
- Intuitively, the contract model does appear likely to best embed the clearest distinction of assets and roles and reduce the possibility of any increased exposure to risk by BSC parties. However, it would be important to note that BSCCo and its board will no longer be able to rely on impartial advice in this matter from its existing Executive in setting up these arrangements given the current governance structure.
- The DCC role will be a licensed activity. It is therefore possible to introduce obligations within that licence that facilitate and reinforce the required operational and financial ring fencing of this activity from any other activity performed by a subsidiary or ultimate controller of the licensee. This could be similar to that adopted within the Distribution Licences in respect of financial ring fencing and separation of businesses requirements.
- The work that would be entailed in setting up the contract model would appear to secure a clearer long-term footing for the change. In terms of the contract term between New Elexon and BSCCo for the core BSC services, we agree with the suggested duration of 3 years. This would allow BSC Parties to cease contracting for core services with New Elexon if the service provision declined unduly due to the distraction posed by the DCC venture, or due to a possible resource allocation imbalance that could develop as between the two. The existence of the three year breakpoint would itself be very important in focussing minds on maintaining core BSC performance and protect the interests of BSC parties.
- For an SEC Panel administration role, a more organic, less radical development of the existing Elexon structure may be suitable, as the issues arising for BSC Parties would be

of a far lesser magnitude compared to a DCC bid. Resources required to affect this would, accordingly, be far less.

- Solely monitoring the quality of Elexon's core BSC performance via a formal automated scoring system would not sufficiently protect the interests of BSC parties. While the current KPIs reported by Elexon are a useful tool in monitoring its current service, they are rather unlikely in themselves be sufficient to provide assurance that service levels will be maintained once Elexon has other business interests. We believe that further work in this area will be required including the possibility of developing the current KPIs together with attempting to define new measures, and even then, the possibility of communal subjective assessment of performance, with action where necessary, remains vital. It is for this reason that the three year breakpoint has particular advantages, as it could be triggered where service quality became unsatisfactory in a way that could not be captured by the current, or developed, KPIs.

EDF Energy
January 2012