BSC Parties, BSC Panel Members
and other interested parties

Promoting choice and value for all gas and electricity customers

Our Ref: 154/11
Direct Dial: 020 7901 7354
Email: industrycodes@ofgem.gov.uk

Date: 21 November 2011

Dear Colleagues,

Open letter consultation: Potential expansion of the role of Elexon

On 30 March 2011 the Department of Energy and Climate Change ('DECC') and the Authority published their joint response to the July 2010[1] prospectus on the Smart Metering Implementation Programme. That response confirmed the Government's intention to create a licensed Data and Communications Company ('DCC') to centrally manage and communicate the large volumes of data arising from the operation of smart meters. DECC is currently consulting upon the regulatory and commercial framework for the DCC.[2]

Elexon Limited ('Elexon') administers the Balancing and Settlement Code ('the BSC') for Great Britain. Elexon's role in operating the settlement mechanism on the industry's behalf is critical to the effective operation of the electricity market. Elexon has built up extensive experience of settlement and the procurement and management of contracts to fulfil its current expert role. Given this experience, Elexon aspires to participate in the competition to be the DCC, as set out its Business Plan 2011-12.[3] However, Elexon's current constitution and certain provisions within the BSC may prevent it from doing so. Elexon considers that Ofgem's involvement is necessary in order to facilitate the removal of these impediments.

Ofgem considers that there may be some synergies between the processes currently run by Elexon and the anticipated role of the DCC, as well as the potential for cost savings from the more efficient use of its fixed assets and other resources. Consumers may therefore benefit from Elexon's participation in the competition to undertake the DCC role. We are therefore in principle supportive of Elexon's desire to diversify. However, the basis of that participation will need careful consideration so as not to undermine the competitiveness of the process, or be detrimental to the BSC arrangements. We therefore commissioned an independent advisor, Richard Morse, to help us understand the issues that may arise from a diversification of Elexon's current role and how these may be addressed. The Richard Morse report was published on 29 July 2011.[4]

This letter does not seek to repeat the detail of the Richard Morse report, or the report produced separately by an Issue Group created under the auspices of the BSC (the Issue 40 Group) which was published on 7 September 2011.[5] However, we do seek views on the conditions that we consider must be met in order for the proposed expansion of Elexon's

[1] www.decc.gov.uk/en/content/cms/tackling/smart_meters/smart_meters.aspx
[2] Smart Metering Implementation Programme: 'A consultation on the detailed policy design of the regulatory and commercial framework for DCC'. September 2011: www.decc.gov.uk/assets/decc/11/consultation/smart-metering-imp-prog/2883-cons-detailed-policy-design-of-dcc.pdf
[3] See: www.elexon.co.uk/pages/corporateandfinancialinformation.aspx
[4] See: www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Elexon%20report%20final.pdf
[5] See: www.elexon.co.uk/ELEXON%20Documents/Issue_40_Final_Report.pdf

role to proceed and the extent to which any of the suggested means of reorganisation (or any alternatives that are put forward) may satisfy those conditions.

Background

National Grid Electricity Transmission ('NGET') is required under the standard conditions of its Electricity Transmission licence to have in place at all times a document known as the BSC. The BSC sets out the arrangements by which BSC Parties may make and accept offers or bids for electricity to be delivered to or taken from the wholesale electricity market, and for the settlement of financial obligations arising from the acceptance of such offers or bids.[6] These transactions total around £1 billion each year.

Elexon currently administers the BSC and is the BSC Company ('BSCCo'). The governance arrangements for Elexon (including corporate structure and funding) were set up with the sole aim of running the BSC arrangements. The BSC currently precludes the BSCCo from undertaking any activity outside of that Code.[7] This restriction currently covers both the BSCCo and Elexon Limited, as they are in effect treated as being the same entity. Elexon presently faces no commercial risk as it has a continuing entitlement flowing from the current arrangements to perform BSC activities, and it receives all of its funding from BSC parties. Therefore, in order to allow Elexon to compete for the DCC, there are two broad options for change:

> **Option 1:** Allow the BSCCo to carry out non-BSC activities; or
> **Option 2:** Distinguish Elexon Limited from the BSCCo and its associated restrictions.

Whilst we would be happy to receive views on Option 1, we consider it can be discounted in the context of the immediate opportunity to operate as the DCC.[8] We believe that it may not be appropriate for the BSCCo to undertake non-BSC activities because this would involve BSC parties (and ultimately electricity customers) assuming responsibilities for activities which are unrelated. The DCC will be governed by the DCC licence and the Smart Energy Code. We believe that given the regulatory arrangements envisaged by DECC it may not be suitable for the BSCCo itself to be the DCC.

We are consulting on Option 2 and the broad approaches that are available on the basis of distinguishing Elexon Limited from the BSCCo. We consider that in order to facilitate Elexon's participation in the DCC competition, there are two sub-options to consider under Option 2, either:

- Establish the BSCCo as a subsidiary of Elexon (the subsidiary model); or
- Separate the BSCCo entirely from Elexon and establish a contract between the BSCCo and Elexon (the contract model), with Elexon as the service provider and the BSCCo as the service procurer.

Below, we set out the conditions we think should be met and summarise our initial assessment of the two restructuring options noted above. A further discussion of this assessment is contained in Appendix 1.

Conditions to expansion

We have identified 4 conditions which are in pursuit of our primary aim of ensuring that Elexon's proposed expansion does not put the BSC arrangements at risk. However, we

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[6] See: www.elexon.co.uk/pages/introductiontothebsc.aspx

[7] Following a consultation process, the Government appointed Elexon to be the operator of the reconciliation mechanism for the Warm Home Discount Scheme. The Government amended the Balancing and Settlement Code (BSC) and Standard Licence Condition C3 of the NGET's Electricity Transmission Licence under powers contained in section 12 of the Energy Act 2010. The consultation and decision documents can be viewed at the following link: http://www.decc.gov.uk/en/content/cms/consultations/warmhome/warmhome.aspx

[8] We are cognisant of the powers contained in section 88 of the Energy Act 2008 which allows the Secretary of State to amend licence conditions and a document maintained in accordance with the licence in facilitation of the smart metering programme. This may include the BSC as it is a document that is required under the terms of the Transmission licence.

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believe that in the event that conditions 1 – 3 are sufficiently met, that this may well meet condition 4 which concerns the fairness of any bid by Elexon to become the DCC. The practicalities associated with implementation of either model and the ease of implementing the necessary changes within DECC's anticipated timelines are also relevant considerations. We recognise that BSC Parties may have further issues that would need to be addressed during the course of development of any BSC modification, licence amendment or other implementation route.

Condition 1: BSC Parties should not face higher costs

We consider that BSC Parties should not be exposed to additional costs as a result of any expansion of Elexon's role. Therefore, any costs arising from the provision of non-BSC services must only be recovered from the customers of such services (or in the event of a loss, the investors in non-BSC services). BSC funds should not, for example, be used as start up capital for the new Elexon activities. Similarly, arrangements need to ensure that there is no pass through to BSC parties of the running costs or security deposits associated with, or bad debt or penalties arising from, non-BSC contracts which Elexon has entered into. Given the scale of these costs are as yet unknown, we consider that any investment in non-BSC activities and the assumption of the associated risks should not be imposed upon BSC parties by virtue of their membership of the BSC.

It follows from this condition that we would expect arrangements to be in place to ensure a proper allocation of common costs between BSC activities and new Elexon activities so that BSC Parties and subsequently customers would be able to benefit from lower costs associated with diversification. Equally, in either model we would expect appropriate governance to be in place (either through a well structured contract or through proper accountability) to assure BSC parties that they are paying no more for BSC services than they would do under the current arrangements.

Finally, we would expect that the cost impact on BSC parties of implementing new arrangements (whether that involves establishing a new holding company or a contract) should be contained and measures should be found to allow BSC parties to recover these implementation costs from the efficiencies gained through the new model.

Condition 2: The arrangements should not place more risk on BSC parties

Currently there is no realistic prospect of Elexon facing financial difficulties as its activities are limited to those set out in the BSC, for which it is guaranteed to recover its costs, being passed through to BSC Parties in the form of BSC charges. Even in the event of a Party defaulting on their payments, the bad debt is allocated to the other BSC Parties on a pro rata basis. Arrangements aimed at allowing Elexon to take on new activities would need to ensure that any financial difficulties that Elexon may face due to its new activities are contained and prevented from spreading to, or adversely impacting upon, the BSC. In particular, we would expect a prohibition on Elexon using BSC revenues or assets related to the BSC activities as collateral for loans to fund other activities. Arrangements would need to be in place to ensure that, should there be distress elsewhere in the Elexon group, someone other than Elexon is able to step in to ensure service continuity.

In principle, it may be possible to meet the Condition 2 requirement either through an arms' length contract with step in rights or through strong ring fence arrangements around the subsidiary providing the BSC services. Issues associated with these approaches are discussed further in Appendix 1.

However, the implication of Conditions 1 and 2 is that Elexon will in all likelihood need to raise capital to fund the start-up and will need new equity to take on the risk associated with new activities (e.g. penalties, bad debt, contract termination). There may also be a need for arms-length trading and cost allocation rules to meet both conditions.

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Condition 3: Standard of service should be maintained

We would need to be convinced that there would be no impact on Elexon's ability to perform its BSC activities, for instance through management time and other resources being diverted towards new activities and opportunities. We consider that this would be a particular risk if those new activities provided a higher return, and/or current activities are not subject to specific and enforceable code or licence obligations.

Whilst there may be an opportunity for BSC Parties to identify areas for improvement in order to prevent loss of capability, we consider that as a starting point it may be appropriate to identify the existing standards of service and prescribe that they should not go below the existing level. For instance, Elexon currently reports to the BSC Panel each month on a number of Key Performance Indicators ('KPIs') as part of the *Elexon Report*[9] and its service desk has published response times.[10] These standards could be set out in a contract which contains penalties or risk of contract termination if they are not met, or enshrined within the BSC itself.

An alternative to output measures may be a requirement upon Elexon management to produce a statement or certificate giving assurance that it will make available whatever resources are required in order to fulfil its BSC responsibilities.

Condition 4: Elexon's BSC role should not give it any undue advantage in the DCC competition

Apart from the appropriateness of using BSC funds as set out above, we are also concerned about the use of BSC funds in facilitating any bid for the DCC. This could give Elexon an undue advantage in a competitive process and/or risk creating a cross subsidy. We would therefore expect to see arrangements for the transparent and equitable allocation of common costs between BSC activities and any new activities Elexon may undertake. This should prevent any perception of the new activities being cross-subsidised by BSC funding Parties, and demonstrate the expected costs savings to those Parties and subsequently to consumers.

We would also wish to ensure that any access to BSC data or systems considered necessary for the DCC bid should be made available to third parties on an equitable basis.

Preliminary views

At this stage we consider that in principle either the subsidiary or the contract model could be developed to address the conditions set out above, but that the contract model has certain advantages that might make the fulfilment of those conditions more certain, and potentially the simpler of the two to implement.

Our current view is that for a subsidiary model under a holding company to be workable, there would need to be a strong ring fence in place to give BSC parties the assurance that they are not funding other activities in the group and that they are not exposed to additional risk. Our concern is primarily around how the ring fence arrangements would be enforced and whether it is possible to introduce effective sanctions into the current arrangements to encourage compliance. Specifically, our concern is that without equity investment in either the subsidiary providing the BSC services, or in the Elexon holding company any penalties or other sanction are likely simply to be passed back to BSC parties.

A contracting arrangement would seem in principle to provide a simpler approach to meeting the conditions set out above. However, this does rely on the service contract being properly structured and we note that this will not be straightforward, particularly in the absence of a competitive tender. We note that the BSC Board would ordinarily be expected to conduct such contractual negotiations and they may need additional resources

[9] Provided to the BSC Panel and published on the Elexon website each month, see: www.elexon.co.uk
[10] See: www.elexon.co.uk/Pages/contactus.aspx

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to do this. Our initial view is that some of the issues with the negotiation process could be offset by the initial contract being for a relatively short duration (e.g. 3 years) and by the contract terms essentially reflecting "as is" costs and service levels. This last point may also make it more achievable to conclude the contract ahead of the DCC tender exercise.

Implementation issues

Irrespective of which model is adopted, there are several pieces of work which must be completed by Elexon and the BSC Parties, such as the creation of any new companies and any contractual and/or governance arrangements between them and the BSC Company/Panel/Board. Changes to the BSC itself, which may be similar under either approach, will be required. Licence changes may also be required, depending on which approach is adopted.[11] We propose to use the consultation time to do more thinking on the measures needed to implement the alternative models, building on the work that Elexon and others have already done. We will present an update of our thinking on this at the stakeholder workshop we propose to hold in December (see below).

Subject to responses to this consultation it is our intention to make a decision on the appropriate model to facilitate Elexon's expansion while protecting the BSC arrangements. It will necessarily take some time to collate and consider the responses, but our present aim is to publish our decision early in the New Year.[12]

Whilst the exact scope of necessary changes to the BSC has yet to be determined, our initial view is that the implementation of these changes could be achieved within the BSC only, without the need to modify licence conditions. That is unless a strong case emerges to change the enduring responsibility and accountability for the operation of the BSC, or to impose further conditions within the relevant licence[13] in order to safeguard the BSC arrangements.

Next steps

We set out a series of questions in Appendix 2. We request that you send responses to industrycodes@ofgem.gov.uk by **6 January 2012**. Following consideration of responses we aim to set out our views on the way forward, including a decision on whether we should pursue a subsidiary or a contract model, in early 2012. We will then work with industry, providing a leadership role to facilitate completion of the necessary work in line with the timetable currently anticipated by DECC.

We would be happy to discuss our initial thoughts and respond to any queries at a stakeholder workshop. Given the availability of parties with a likely interest, we propose to hold this event to follow the BSC Panel on **8 December 2011**. If you would like to attend this event, could you please confirm via the above email address by **2 December 2011**. We will confirm the precise start time nearer the date. In parallel to this consultation, it would be helpful if a group could be convened to consider the necessary changes to the BSC itself.

If you have any questions with regard to this letter please feel free to send an email to the above address.

Yours sincerely

Rachel Fletcher
Acting Senior Partner, Distribution

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[11] E.g. if appropriate, in relation to NGET's role.
[12] We presently aim to publish our decision in late January / early February – we will in terms of timing be cognisant of DECC's timetable in relation to the DCC process.
[13] See footnotes 7 & 11 – the relevant condition is Standard Licence Condition C3 of NGET's Electricity Transmission Licence.

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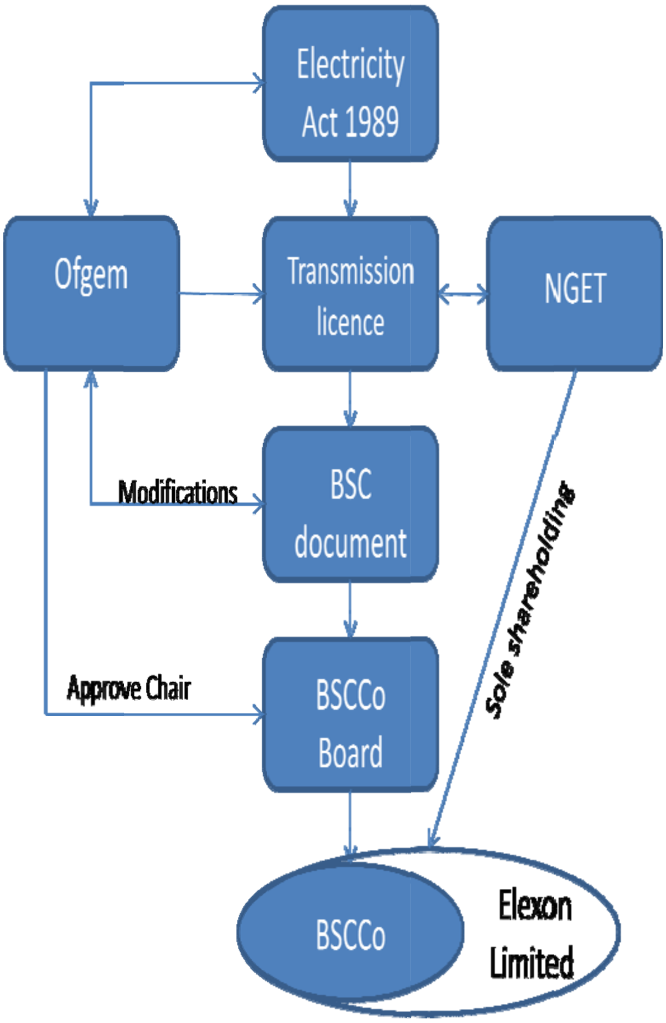
Appendices

Appendix 1 – Summary of the organisational options

1. Introduction

A high level illustration of the existing BSC governance is set out below:



- NGET is obligated under its transmission licence to have in place a BSC document.
- NGET is currently the sole shareholder in the (dormant) BSCCo Limited[1] and Elexon Limited,[2] but does not sit on the board.
- The role and responsibilities of BSCCo are as set out in the BSC.
- The BSC currently defines BSCCo as meaning Elexon Limited (or any successor to that company acting in the capacity as BSCCo); there are no other references to Elexon Limited in the BSC or licence.
- The articles of association of Elexon Limited state that its role is to act as and perform the functions which are ascribed to the BSCCo as set out in the BSC.
- The BSC prevents the BSCCo from carrying out activities other than those provided for in the BSC.

The BSCCo cannot currently carry out non-BSC activities. This restriction currently covers both the BSCCo and Elexon Limited, as they are in effect treated as being the same entity. Therefore, in order to facilitate Elexon's participation in the DCC competition, there are two broad options, either:

Option 1: Modify the BSC to expand the activities BSCCo may undertake;
Option 2: Distinguish Elexon Limited from the BSCCo and its associated restrictions.

As stated in our consultation letter, we consider that we can discount Option 1 at this time, particularly in the context of the immediate opportunity to operate as the DCC. The DCC will span both electricity and gas, and will be governed by a DCC licence and the Smart Energy Code, as set out in DECC's Smart Metering Implementation Programme consultation.[3] We believe that given the regulatory arrangements envisaged by DECC it would not be suitable for the BSCCo itself to be the DCC.

[1] Company registration 3837126.
[2] Company registration 3782949. The name of the company was changed from Intercede 1442 Limited to BSCC Limited by special resolution on 13 July 1999 and to Elexon Limited by special resolution on 31 May 2000.
[3] Available on the DECC website.

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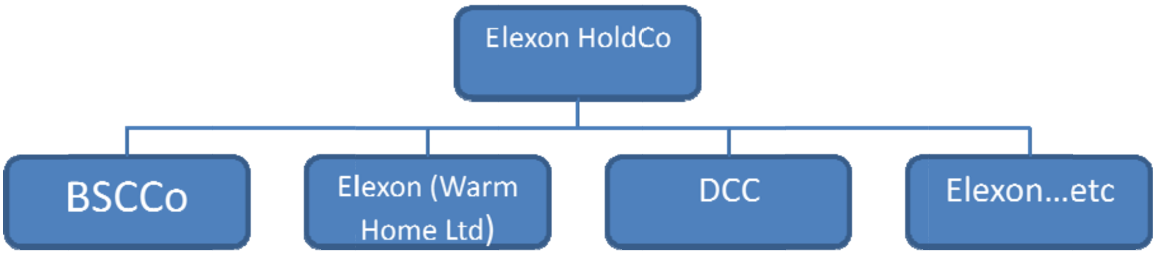
Therefore, we are now consulting on the approaches available under Option 2. As stated in our consultation letter, there are two sub-options to consider under Option 2, either:

- **establish the BSCCo as a subsidiary of a new Elexon holding company (the subsidiary model); or**
- **separate the BSCCo entirely from Elexon, set it up as a commercial entity[4] and establish a contract between the BSCCo and Elexon (the contract model).**

Each of these models is set out in detail in both the Morse[5] and the Issue 40 Group[6] reports and are therefore not repeated at length here. However, we set out a high level summary below, to give context to the further discussion within this appendix.

The subsidiary model

The subsidiary model requires the creation of a new umbrella holding company, which would be the parent of an Elexon Group of companies, each formed to fulfil a special purpose, i.e. the BSCCo, the Warm Home Discount Company and so on. Under this model, the ownership of the BSCCo would transfer from NGET, to become a wholly owned subsidiary of the new holding company.



We would expect that the holding company and the BSCCo would have separate board membership, ensuring that there are no conflicts in representing the interests of their shareholders or, as the case may be, funding parties. The role of the BSC Panel and the BSCCo Board should therefore remain specific to the BSC. We would also expect there to be distinct management structures for each of the other subsidiaries, though these are details for the Elexon management and, to an extent the counterparties of each contract, to consider.

Other than for its ownership, the BSCCo would remain unchanged in structure and funding, remaining a not for profit company with all of its costs passed through to BSC Parties. However, new business ventures could be created under the holding company, to compete for commercial opportunities as they arise. The subsidiaries could be either not for profit or profit making, with equity shareholders at subsidiary level. In the case of the DCC, it is expected that this will be a profit making entity governed by a licence. By contrast, in this model the assumption is that the BSCCo would remain a not for profit company with any excess revenues returned to BSC Parties, as now.

The contract model

Under the contracting model, the ownership of the BSCCo could remain as it is. Any activities that do not remain 'in-house' could be provided through a service contract between the BSCCo and the new, commercial for profit, service provider. The BSCCo would procure and manage that contract.

[4] This could be achieved through activating the currently dormant BSCCo Ltd, rather than setting up a further company.
[5] See: www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Elexon%20report%20final.pdf
[6] See: www.elexon.co.uk/ELEXON%20Documents/Issue_40_Final_Report.pdf

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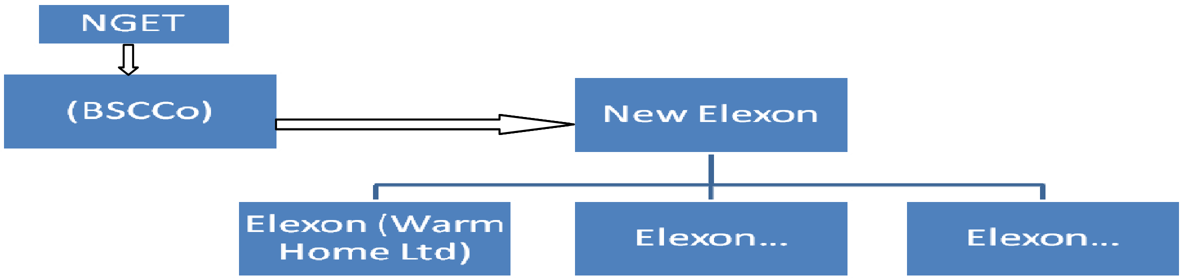
The new service company could be owned by those BSC Parties (and any other interested parties) who are willing to invest in it. The new service company would be able to compete for other business in the industry including the DCC. The BSC service contract could include a profit margin and appropriate incentives. The profit (or loss) made from the BSC service contract (and from other activities) could either be invested in the new company (or group) or distributed to shareholders.



The new Elexon service provider could also undertake to perform other services as a contractor and / or establish itself with a corporate structure which allows it to create subsidiaries to compete for other business opportunities in the industry.

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2. Issues and concerns

Issues

The table below attempts to summarise the issues which arise under each model when considered against the conditions we set out in our letter.

Table 1

Issues arising from the alternative models		
	Contract Model	**Subsidiary Model**
Additional costs to BSC Parties	• Set up costs will need to be managed and measures introduced to allow them to be recovered to BSC parties as efficiencies emerge • Risk that the contract negotiation does not manage to secure the principle of keeping BSC parties at least financially neutral • Additional costs to BSCCo, to the extent the contract contains a profit margin and this is not offset by efficiency gains built into the contract • Difficulty in securing a fixed price for a contract of this nature and being sure that the price that has been struck in the contract provides a good deal for the BSC parties • Need to ensure BSC parties gain some benefit from efficiency gains from shared services and that costs of shared services are fairly distributed	• Set up costs will need to be managed and measures introduced to allow them to be recovered to BSC parties as efficiencies emerge • Arrangements are required to assure the BSC parties that their funds are not being used to fund other activities • Strong transparency and accountability arrangements would need to be put in place • Need to ensure that the BSC parties benefit from shared costs when the HoldCo wins extra work

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Additional Risks	• Need to ensure that the contract is structured in a way that allows the BSC to hand over the services to another organisation if Elexon fails to perform/becomes insolvent • Need to determine what level of resources/assets stay with the BSC and what go to the new commercial entity • Need to ensure that Elexon holds sufficient equity in it to enable it to carry risk associated with non-BSC activities • Not clear whether even if only carrying out BSC activities, Elexon will need equity to carry risk associated with the new contract	• Ring fence provisions would be required to protect the BSC subsidiary from financial failure elsewhere in the group • Not clear how those ring fences would be enforced • A new licence may be required • What NGET's role would be is not immediately apparent • To avoid securitisation of BSC assets/revenue streams, need to ensure that there is capital injection into the HoldCo or subsidiaries taking on other work
Levels of service	• Need to ensure that the contract can stipulate service levels (based on current performance measures) given the need for Elexon to be responsive and flexible • Restricted scope/motive for service provider to respond to unforeseen problems/ contracted events	• Whilst existing Key Performance Indicators (KPIs) would provide a starting point for defining service levels, it is not clear that these would adequately ensure that service levels would not decline. • Not clear what actions the BSC Panel would be able to take if standards are not maintained • No prospect of financial incentives for service improvement – costs passed through to parties • Arrangements needed to ensure the subsidiary is accountable to the BSCCo Panel / Parties
Unfair advantage in DCC competition	• Need to ensure fixed costs are allocated fairly across contestable activities (possible solution – prospect of contract renewal). • Need to ensure other parties not put at disadvantage (possible solution - contract to include intellectual property rights (IPR) to be licensed on equivalent terms to any party)	• Need to ensure fixed costs are allocated fairly across subsidiaries. • Licensing of IPR could be set out in BSC
Implementation	• Need to create the contract and decide who would negotiate contents • May need to provide additional resources to BSC Panel or Board for contract negotiation • New service provider company needs to be created • Minimal BSC/licence changes	• Arrangements for new HoldCo company to be created • Establish to what extent Elexon would be accountable to BSCCo Board/Panel and what mechanisms would be in place to ensure accountability • Significant BSC and other changes if additional protection (ring fencing) is required • Need to determine NGET's role

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Our concerns

As set out in our letter, we are primarily concerned with ensuring that Elexon's proposed expansion does not put the BSC arrangements at risk, however, the fairness of any bid to become the DCC and the ease of implementing the necessary changes within DECC's anticipated timelines are also relevant considerations.

BSC Governance

The extension of Elexon's scope would present a set of challenges that were not envisaged at the time the current arrangements were put in place as part of the New Electricity Trading Arrangements ('NETA').[7] It is therefore appropriate to consider whether the governance, funding and ownership of the BSC remain fit for purpose, let alone the most effective organisational structure.

As part of the NETA conclusions, it was considered that the fact that the BSC Board will be non-executive and include representatives of those paying BSCCo fees would reassure participants that there would be sufficient transparency, scrutiny and control of costs. We consider that this arrangement has worked reasonably well to date. However, the expansion of Elexon is likely to place a greater burden on the BSCCo Board in discharging their fiduciary duties to BSC Parties than it has faced in the past. This may be the case either in terms of negotiating and managing a suitable contract with a service provider that has hitherto acted as its executive, or in ensuring the provisions of the BSC are fully discharged and any ring fencing arrangement honoured by the subsidiary of the holding company.

Further detail on the current BSC governance arrangements is contained in Appendix 4.

We address the specific issues arising from the governance arrangements and ownership of BSCCo in relation to each model below.

3. Contract Model

Our key concerns in relation to this model are whether it can protect BSC parties, whether the BSC has the necessary resources to create such a contract and the extent to which the issues raised would be addressed if the BSC parties were to enter into a relatively short-term contract that will be re-tendered upon its expiry.

Costs

As set out in Table 1, we recognise that there will be start up costs in the creation of a new contract between BSCCo and the new service provider. However, it is likely that similar costs would be incurred in the creation of a holding company and potentially a comparable amount of development and negotiation, albeit with the end result being modifications to the BSC and/or agreements between the various parts of the new group rather than a contract. We do not consider that the start up costs would of themselves be sufficiently different between the contracting and subsidiary model to be the determining factor in which model is adopted.

However, it is likely that any contract would need to include a premium, both to incentivise the service provider to match or exceed agreed standards of service, but also to reflect the risk that they will be undertaking, not least that the contract may not be renewed. There will therefore be a natural tension between certainty of a lengthy contract and the safeguard that the option of renewal provides. The extent to which the start up costs of

[7] See: The New Electricity Trading Arrangements. Ofgem/DTI Conclusions Document. October 1999

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the contracting model will be outweighed by its benefits may be dependent upon the ability of the BSCCo Board to identify future costs efficiencies; the value BSC Parties place upon any service improvements; and the ability of the BSCCo Board to secure them.

We consider the Contract Model to have an advantage in terms of costs, as once the contract is struck, BSC Parties' funding responsibilities are crystallised and BSC parties will have assurance that they cannot be called upon to cover the costs associated with any non-BSC activities.

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?

Do you agree with our view that start up costs themselves do not provide a sufficient basis for determining the appropriate model?

Do you consider that the benefits of the contract model would likely outweigh the additional cost of a premium?

Risk

We consider that it should be for the BSCCo Board acting on behalf of BSC Parties to determine the precise nature of the contract between the BSCCo and the service provider. While the BSCCo Board has in the past been responsible for signing off substantial contracts, for instance with IT providers, this has been with the support of Elexon staff. However, the obvious conflicts of interest may mean that this arrangement would not be suitable in this instance. We would therefore be concerned if the BSCCo Board was not able to effectively negotiate a robust contract that effectively protected the interests of BSC parties.

It may therefore be necessary to augment the existing BSCCo Board, either in the short term or on an enduring basis, to ensure that it has the necessary time, resource and expertise at its disposal to secure a suitable contract. This could either be in the form of:

- additional BSCCo directors;
- a dedicated budget with which to procure advice and expertise;
- a specially convened committee, drawn from BSC Parties; or,
- the early assignment/recruitment of suitable staff to work for BSCCo on an enduring and dedicated basis.

We consider that any risk of the contract being less than optimum from BSC Parties' perspective may be mitigated if it was initially for a relatively short period, for instance two to three years. A requirement could then be placed upon the BSC Board to retender that contract as appropriate.

We would also need to be assured that the BSCCo Board would be able to deliver a continuity of service to BSC parties in the event that the service provider was not to be reappointed after the initial period, or if it was required to step in and/or replace the contract in the event of the service provider failing. Consideration should therefore be given to whether the BSCCo should retain certain core assets and functionality 'in house'. The possibility of BSCCo retaining all assets and leasing these to the new Elexon could be considered, particularly if a relatively short contract is initially agreed as it may provide more flexibility to BSCCo at the time when the contract is retendered.

Our initial view is that the existing contracts with third parties for IT and other services should probably be retained within BSCCo. This will provide assurance to both BSC Parties that business continuity can be maintained in the event of the new Elexon failing. Given the low risk and certainty of revenues that the BSCCo enjoys, it may also be necessary for

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it to remain as the counter-party in order to assure those existing service providers that there is no greater risk of default on their payments than under the current arrangements.

What resources/support would the BSC board need to negotiate the contract?

Do you consider that core assets and functionality should remain with the BSCCo or be transferred to the new Elexon?

What are your views on which assets and functionality should be retained?

Do you consider that the BSCCo should be given a right of 'step in'?

Service levels

As set out in Table 1 above, we believe that the issues which arise in relation to this condition relate to the difficulty of stipulating service levels and incentivising performance given the flexible nature of current arrangements and the need for Elexon to be responsive.

We consider that the initial contract between BSCCo and the service provider could largely reproduce the existing arrangements. For instance, Elexon currently reports to the BSC Panel each month on a number of Key Performance Indicators ('KPIs') as part of the *Elexon Report*[8] and its service desk has published response times.[9] These standards could be set out in a contract which contains penalties or risk of contract termination if they are not met.

The initial contract could be for a short period of time. The absence of a guarantee of renewal should ensure that standards are maintained in the short term, though it may eventually be necessary to develop an incentive mechanism. This could be linked to the amount payable by the BSCCo under the terms of the contract.

Do you consider this approach to be suitable for ensuring that incentives exist for performance and that service levels are sufficiently defined and secured in any contract?

Implementation

While the structural change associated with a contract would appear to be significant, we consider that the changes to the BSC itself would be minimal and relatively easy to achieve. The key need would be the effective management and resourcing of BSCCo once it is activated as a separate company, rather than any change to the activities it can carry out under the BSC.[10]

The BSCCo already has the ability to outsource activities as Section C 3.1.1 of the BSC provides the powers, functions and responsibilities to enter into, manage and enforce contracts with service providers (as BSC Agents) for the supply of services required by the BSC Service Descriptions. The BSC Service Descriptions and the roles assigned to BSC Agents are set out in Section E of the BSC. We consider that it would be relatively straightforward to make any necessary changes within Section E. All other matters relating to the management of the contract would be handled in the same manner as other BSC Agent contracts, which already account for around half of the annual BSCCo budget.

It will be largely for the management of Elexon in discussion with the BSCCo Board to determine the specific terms of the contract, including which of the existing functions should appropriately sit under the BSCCo and which will be retained within Elexon. We set out some concerns and questions about the BSCCo's ability to negotiate a contract without further allocation of resources in our section on risk, above.

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[8] Available on the Elexon website
[9] See: www.elexon.co.uk/Pages/contactus.aspx
[10] BSCCo's activities are restricted by Section C1.2.2 BSC.

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One concern which has been raised is that the re-allocation of roles and responsibilities may lead to issues with respect to the Transfer of Undertaking (Protection of Employment) ('TUPE') Regulations. This is primarily a matter for the management of Elexon Limited and potentially the BSCCo to resolve, rather than a matter for Ofgem. However, we consider that there may not be a material difference whether any transfer of staff relates to the BSCCo or to a new holding company.

The Issue 40 Group report raised the possibility that any new contracting arrangements between the BSCCo and the new service provider would need to follow the Official Journal of the European Union (OJEU) procurement process, which may not be completed within the available time.

It is difficult to reach a definitive conclusion as to the procurement law consequences of any new arrangements without a full understanding of the precise form of the proposed new structure, the contracts that would be awarded both to and between the new companies and the timing of this, and the ownership and governance arrangements for those companies. However, we do not consider that the unbundling of existing arrangements, with separation between BSCCo and a new Elexon being affected by a service contract between the two will require a tender following the OJEU process. It would however be best practice going forward for the contract to be subject to periodic re-tender.

We also note a further issue raised by the Issue 40 Group report, which questions whether the contact model would be viable if the new Elexon company is not successful in attracting investment. We are not convinced it is essential that the new company attracts new capital if the scope of its activities are limited to the contract with the BSCCo, although we are interested in views on this point. Moreover, even if it were considered that the new company would need to attract a partner, it may be possible to address this risk by reaching agreement on the contract model and all necessary code and governance changes in principle, but not implementing this immediately. In the event that an equity partner is found, the agreed arrangements would then be implemented, but if no equity partner is found, it would be possible to revert to the status quo. However, this approach would involve significant expenditure which may not lead to any change.

We invite views on our assessment of the implementation challenge and particularly on whether the success of this model relies on Elexon securing a business partner.

Competition

As set out in Table 1 above, to prevent the BSC contract giving Elexon an unfair advantage our key concern is to ensure that BSC revenues are not used to fund other Elexon activities. This means that BSC parties must be able to negotiate a fair price in the contract with Elexon, including establishing a fair allocation of shared costs. There is also a need to ensure that BSC resources (including intellectual property rights (IPR)) are available to other parties on equivalent terms. We consider this will be achieved if the contract is properly negotiated.

4. Subsidiary Model

Our key concern in relation to this model is whether it is possible to design effective and enforceable ring fencing arrangements and other governance arrangements which ensure that BSC parties have control over the subsidiary and are not exposed to deterioration in value for money, service or an increased risk related to Elexon taking on non-BSC activities.

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Costs

As discussed in Section 3 above and in Table 1, we consider that similar costs may be incurred in the creation of a holding company as in a contracting arrangement, albeit any provisions would be given effect through the BSC, agreements between the various parts of the new group and possibly in the Transmission licence.

Direct costs to BSC Parties may be lower than under a contracting model to the extent that there would be no need for a margin or a risk premium to be built into the charges. The ability of the BSCCo Board to identify and realise cost savings may be limited under a subsidiary model compared to the contract model, which could include incentives for cost reductions. However, we note that the annual operating costs of Elexon Limited have generally fallen year on year even without the contracting mechanism being in place.

Under the subsidiary model it will be essential for the BSC subsidiary to provide BSC parties with full transparency of costs and there may be a requirement for improved accountability measures given that BSC parties will want to be assured that the costs of other activities are not being passed through to them. Our concerns and examination in relation to ring fencing, set out below, are also relevant. We welcome your views on what, if any, changes to current Elexon reporting arrangements would be required to provide BSC parties with the appropriate level of assurance that they are not funding non-BSC activities.

Risk

In the absence of separation between the BSCCO and its service provider(s) with an effective and enforceable contract, we consider that many of the mitigating measures that would in a normal commercial context be left in the hands of the BSCCo Board could instead be codified. Recognising the unique position of the BSCCo and its importance to the electricity market arrangements, we consider that these safeguards could appropriately replicate those that are in place for other natural monopolies such as network operators, as set out below and in Appendix 3.

Ring fencing the BSCCo

We would consider whether our concerns could be met by way of a financial ring fence.

The purpose of any ring fencing provision would be two-fold. Its primary purpose would be to ensure that the assets, cash-flows and other financial resources are applied to meet the needs of the BSC parties. It would ensure that resources sufficient to meet the needs of providing the BSC function would not be diverted to any other purpose nor exposed to any unrelated risks, for example if one of the other subsidiaries, or the holding company itself, faced financial distress. The second purpose would be to ensure that the party responsible for enforcing the ring fence has access to information to monitor compliance with the provisions and would for example be able to consider what action to take in the event of a breach or early warning of severe deterioration. As such, they may also provide the basis for enforcement action.

It is not currently clear whether the BSC Panel or the BSCCo Board would be able (or indeed willing) to effectively hold Elexon to account if it is a subsidiary to a holding company, nor what recourse BSC Parties would have. While NGET has certain obligations should the BSC Panel fail to discharge its own duties, these are largely procedural in nature[11] and do not extend to the rights to remove directors etc that would ordinarily be afforded to shareholders.

In order to address this lack of enforceability, we could, in principle, seek to enhance the provisions of NGET's licence, putting in place new responsibilities for it to monitor and

[11] These 'step in' provisions relate to Accession to the BSC, Operation of the Modification Procedure and the provision or publication of data.

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where necessary enforce any ring fence provisions. Although the Authority has powers to fine licensees for a breach of licence conditions, it is not clear whether this would be an appropriate let alone effective sanction given the arms length relationship NGET as the responsible licensee has with the BSCCo. It would also be impracticable to impose any financial sanctions upon Elexon, as these costs would simply be passed through to BSC Parties.

Alternative sanctions such as linking the remuneration of the CEO/Chair of the BSCCo to performance may be available. The effect of this incentive may be negated if there was greater pressure (or incentive) to breach the ring fence in order to deliver performance elsewhere. Again, the effectiveness of this would rely on the BSC panel and BSCCo Board having sufficient transparency of Elexon's operations as a whole to determine whether performance under the BSC was being impeded as a result of activity elsewhere.

We welcome views on these issues and on the merits and enforceability of a ring fence of the BSCCo generally.

Special administration

The BSC is not captured under special administration arrangements such as those which exist to mitigate the risk of failure of a network licensee. It could be argued that the BSC arrangements have a similar degree of importance to the electricity industry. It may be appropriate to consider whether the responsible licensee should be obligated to ensure that a BSCCo is in place at all times. Therefore, if there was a credible risk of the BSCCo failing, the licensee would essentially be required to 'step in'.

We invite views on this issue.

Service levels

We consider that it would be relatively simple to codify the existing standards of service. Whilst these may already be set out elsewhere, we consider that their inclusion in the BSC itself may be necessary in order to create a clear obligation and to the extent necessary, the vires for the BSCCo Board to ensure that sufficient resources are being provided to meet those obligations.

We invite views on our assessment of this issue.

Competition

As set out in Table 1 above and in line with our concerns under the contract model, there is a need to ensure that fixed costs are allocated fairly so that the BSC contract does not unfairly advantage Elexon and the need to make BSC resources (particularly IPR) available to other parties on equivalent terms.

We invite views on our assessment of this issue.

Implementation

We consider that the subsidiary model may require a considerable amount of modification to the BSC, and perhaps the transmission licence, in order to mitigate the risks identified in Table 1 and thereby satisfy the conditions set out in our letter. These challenges would be compounded if having considered responses we were to conclude that the safeguards we are looking for could not be effectively discharged.

We may then need to consider whether the necessary provisions could be more effectively enforced by an alternative responsible licensee, or even whether the BSC arrangements are of sufficient importance that they should appropriately form a licensable activity in their

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own right. Subject to responses regarding the additional safeguards that we may seek to place around the BSC arrangements as mentioned above, we would not look to make any substantive modifications to the existing licence conditions as part of any migration of obligations from the transmission licence.

Notwithstanding these concerns, we consider that the potential BSC modifications identified under Section 3 would apply equally to the subsidiary model to the extent that services are being carried out by an organisation other than BSCCo or Elexon Limited.

We invite views on our assessment of the implementation challenge.

5. Conclusion

We have set out what we consider to be the conditions which must be met in order for us to accept any expansion of Elexon's role whether under a subsidiary or a contract model. We acknowledge that the proposed not-for-profit nature of the holding company may ensure that as Elexon expands, the value is retained within the electricity industry and may ultimately benefit electricity consumers, rather than being paid out as dividends to as yet unknown investors. However, we also consider that the new investment would bring benefits to the expanded Elexon and may provide an additional safeguard against its failure to continue providing an effective service to the BSCCo. More fundamentally, it seems essential to us that any new activities should be funded by willing investors rather than by using mandatory BSC funding for this purpose.

Our current view is that for a subsidiary model under a holding company to be workable, there would need to be a strong ring fence in place to give BSC parties the assurance that they are not funding other activities in the group and that they are not exposed to additional risk. Our concern is primarily around how the ring fence arrangements would be enforced and whether it is possible to introduce effective sanctions into the current arrangements to encourage compliance.

At this stage our preliminary view is that a contract between the BSCCo and Elexon as its service provider, constituted largely in line with the current arrangements between BSCCo and Elexon, would seem to offer several benefits relating to the key issues set out in our letter. In particular, while it will be time consuming to negotiate, an effective contract would provide all parties with assurances that costs associated with other activities are not being passed through to them and would insulate them against the risk associated with other activities. A contracting arrangement would seem to require the least change to the BSC arrangements themselves, though the timely implementation of these changes would be required in order to allow time for contract negotiation and to fit in with the timescales for the DCC tender. A further opportunity for more thorough renegotiation and/or market testing could be assured by limiting the initial service provision contract to a relatively short period, for instance, 3 years.

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Appendix 2 – Consultation questions

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

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

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

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?

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?

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

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

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

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?

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Appendix 3 – Ring fencing

In March 2011 Ofgem published its consultation on proposed modification to the 'Ring Fence' Conditions in Network Operators licences. We consider that many of the safeguards suggested in that document may provide useful pointers for the BSCCo, as set out below:

1) Restrictions on the disposal of assets

This condition would essentially prevent the disposal of assets without consent. With the prospect of BSCCo outsourcing more of its activities, we may want to give consideration to which assets are considered crucial to its effective operation. The BSCCo Board will be well placed to determine which assets it must retain 'in house' in order to achieve business continuity, though it may also be prudent for the BSC to require the BSC Panel to sanction this decision.

2) The requirement to have all necessary resources available to run the business

The BSC Parties may wish to place a requirement upon the BSCCo board to produce a statement or certificate that all necessary resources will be available for the fulfilment of the BSC activities. The management of the holding company would in turn be required to discharge this commitment, or in the case of a contract it would need to be a condition of that contract.

3) Undertakings from the ultimate controllers of the company regarding licence compliance

In the case of a licensed company, it may be possible to obtain an enforceable undertaking from the ultimate controller of the company, stating that they will not do anything which would cause the licensee to be in breach of its licence. This provision may have little relevance in the current scenario where NGET is both the owner and responsible licensee for the BSCCo. However, an arrangement along these lines could become relevant if the BSCCo were to become a licensable activity.

4) Restrictions on indebtedness and the types of payments and transfers that can be made to affiliates

Such a condition would restrict the types of payment and transfers that could be made to affiliates. A similar restriction already exists within Section C 3.4.3 (b) of the BSC. This may need to be revised in light of any new organisational structure, although the prescription that any payment or transfer of funds should be for BSC purposes should be retained.

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Appendix 4 – Current BSC Governance Arrangements

It is important to note that unlike Panels on other industry codes, the role of the BSC Panel is not limited to overseeing the modification process, but extends to the management and implementation of the BSC rules. At the time of New Electricity Trading Arrangements (NETA) the BSC Panel was seen as being the key body tasked with ensuring that the BSC is effectively and efficiently managed, and that appropriate revisions to the trading arrangements are secured in a robust and timely manner. This was to counteract the prevalence of vested interests which existed under the previous Electricity Pool arrangements.

Therefore, the constitution, functions and process of the BSC Panel are clearly defined within the BSC. BSC Panel members are obliged to act independently in carrying out their functions as Panel members. Decisions should be made with regard to the objectives set out in the transmission licence, rather than through negotiation between competing commercial interests. These principles are further assured through independent experts having a broadly equivalent number of places on the BSC Panel as individuals employed by industry parties. The current BSC Panel membership can be found on the Elexon website.[12]

There is a degree of overlap between the governance responsibilities of the BSC Panel and the BSC Board. For instance, while the BSC Panel approves the Elexon business plan, the budget to deliver that plan is subsequently subject to agreement by the BSC Board, of which two directors are BSC Panel members. We do not consider that the constitution of the BSC Panel needs to be revisited as part of this project, although the extent to which Elexon and the BSC Board are accountable to the BSC Panel and BSC Parties more generally may need to be considered.

As part of our Code Governance Review Final Proposals[13] we clarified that we would retain the requirement that each of the main codes has an independent chair, but that we would not seek to prescribe how that chair should be selected. We also confirmed that the Authority would have a right of veto over any candidate put forward by the licensee. We effected this change through modification of the transmission licence.[14] It would therefore be appropriate for the BSC to be modified to clarify that the chair of the BSCCo and the BSC Panel will not in future be appointed by the Authority.

Under BSC rules, the BSCCo chairman appoints two non-executive directors, with a further two non-executive directors being selected from the BSC Panel membership. We should note that while the Authority has historically appointed the BSC chair, it has had no influence over the Chair's subsequent selection of non-executive directors. Also, although NGET is the sole shareholder of BSCCo and Elexon Limited, it does not have a seat on the board. There are no executive directors.

Although NGET is the sole shareholder in the BSCCo it has no direct role in the management of the company and very limited obligations in the event that something were to go wrong. In particular, NGET has no liability or obligation to provide any finance or financial support to the BSCCo or any of its subsidiaries.[15] To the extent that NGET has any 'step in' obligations they are procedural only.

[12] http://www.elexon.co.uk/Pages/bscpanelmembers.aspx
[13] Code Governance Review – Final proposal, March 2010. Ref: 43/10
[14] Standard Condition C3 (1)(f)
[15] See Section C2.4 BSC

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Appendix 5 – Indicative timetable

We are conscious that the invitation for those wishing to be considered for the DCC is scheduled to commence during Q2 2012, though we understand that this will not be early Q2. We therefore consider that there is sufficient time for industry to progress the necessary BSC modifications through the normal process. The greatest variable is likely to be the development and negotiation of the contract. We are therefore willing to facilitate those discussions to the extent our assistance is required.

Below we set out an indicative timetable for the progression of the BSC modification proposals. We assume that a modification may be raised in time for the February 2012 panel, though in practice there is nothing to prevent a modification proposal being raised sooner. Arrangements outwith the BSC such as the establishment of the new Elexon Company and drafting of the framework contract can also take place in parallel with this consultation, ahead of the modification being formally raised.

To the extent that these preliminary pieces of work are not completed and DECC confirms the Q2 commencement of the DCC competition, we may need to give consideration to whether urgent status is required for any facilitating modification.

Table 1 – indicative timetable for modifications

Date	**Action**
8 December 2011	Ofgem host round table discussion on proposals Issue Group (re)convened to consider necessary modifications to BSC
6 January 2012	Consultation closes
Early 2012[16]	Decision/way forward document published
February 2012	Modifications raised
February 2012	First Panel discussion
May 2012	Panel Recommendation
Q2 2012	Ofgem decision

[16] We presently aim to publish our decision in late January / early February – we will in terms of timing be cognisant of DECC's timetable in relation to the DCC process.

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