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30th December 2011

Dear Ms Fletcher

Potential expansion of the role of Elexon

Thank you for the opportunity to respond on the proposed expansion of the role of Elexon.

The industry is facing the widest level of change since market opening - EMR and Smart metering will bring changes to the way the market operates, and while improvements to the settlement arrangements was not one of the main drivers for the introduction of smart metering it is clear that settlements will evolve as a result of the increased data in the industry. Elexon role has always exceeded that of the conventional code administrator; extending beyond governance and code support activities into procurement, contract management, analysis and assurance of the systems that support the industry settlement arrangements and because of their experience in adapting to change it is right to consider how they can help deliver the other changes the industry is facing.

We are supportive of Elexon's desire to diversify as we believe they do have skills and expertise that can be utilised outside of the settlement arrangements which could be of benefit to the wider industry as it changes to meet the challenges of Smart Metering and the

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Electricity Market Reforms. This is heavily caveated by the proviso that the appropriate safeguards are put in place to protect BSC Parties from the risk attaching to the commercial activities Elexon may undertake if this change were to go ahead, since currently the BSC Co is in a very safe situation in that its activities may not be underfunded.

Consultation questions

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

Yes – the protection from higher costs and the unwanted risks that may be introduced by the changes, but at the same time ensuring that the same standards of service are maintained whilst recognising that Elexon should not have a competitive advantage over other parties in preparing their bid for the DCC are critical requirements for expanding Elexon's role.

Higher Costs: Currently BSC Co's costs are fully underwritten by BSC Parties; therefore BSC Parties should not face higher costs as a result of non-BSC activities. We believe that whatever mechanism is used to allow Elexon to diversify must protect those who choose not to invest in any future non-BSC activities from any financial risk or consequence.

Greater Risk: It is inevitable that there will be risk associated with the expansion of Elexon. Whilst it is easier to set up mechanisms to minimise the financial risks there may be other risks that maybe less obvious – the allocation and use of people resources between the BSC Co and the new organisation, management distraction, and employee impacts as well as cash flow, but it should also not be forgotten that the Balancing & Settlement Code itself will be going through a major time of change with the aspiration of the introduction of a move to Half Hourly Settlement with the availability of increased metering data. The modifications raised to change the settlement arrangements to HH are already stretching Elexon resources

Maintained Standards of Service: Elexon have made great efforts in the past to deliver continually improving service whilst reducing cost. This has been achieved by focusing on a set of core activities and having only a single set of objectives to deliver – the Balancing & Settlement Code. It will be an exciting time for the management of Elexon looking to broaden its range of activities to include new things which will introduce a risk that without agreed delivery standards to be met the consequential distraction could have a detrimental impact on the delivery of the key services. It is therefore essential that Standards are base-lined and reported against and appropriate sanctions considered for failure to deliver.

Competitive Advantage: Being part of the competitive energy industry we would not want there to be any suggestion that Elexon's bid for the DCC or any other activity could be considered to have benefited from a competitive advantage afforded to it by nature of its funding by BSC Parties.

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

We firmly believe the contract model better meets the conditions for a change in Elexon's role. The contract model gives BSC parties absolute certainty that the costs of Elexon's commercial activities in no way attach to BSC parties who choose not to invest in the commercial activities of the new organisation. While Elexon have been keen to reassure BSC parties that the activities of the new Hold Co will have no impact on them, there are a number of financial and other risks that cannot be mitigated through the subsidiary model:

a) Investment: Under the subsidiary model, without outside investment, even if resources are used on a "rate-card-commercial basis" between Elexon's new Hold Co and the BSC Co., should the new organisation fail to win any new business it will have no revenue from which to return the value of those resources to the BSC Co and the loss will have to be met from BCS parties under their code obligation to ensure that the BSC is not under-funded.

In the contract model, Elexon should find it easier to attract investors. The contract itself is an asset which will produce future revenues and can be used to generate investment; similarly the pool of available investors will be wider than BSC Parties.

b) Financial ring-fencing: To give BSC parties the level of reassurance they would need for the subsidiary model, it would be necessary to put in place the type of business separation that exists for the vertically integrated utility companies where regulated and non-regulated activities are undertaken. Separate premises, accounts, resources –both physical and personnel would be needed, but in view of the size of Elexon this level of separation is likely to be too expensive and time-consuming to be cost effective, and the risk is that if done on a "paper basis" it is likely to become ineffective in times of high demand/stress. The question is then – who pays for that business separation, the parties being protected or the parties taking the risk. If we are to meet Ofgem's requirement that BSC parties must be protected it would have to fall on the new business. With the contract model – this risk is completely removed, as the service costs are determined in the contract and the service provider is unfettered in how it utilises its resources - provided of course it meets its contractual obligations.

c) Budget: BSC parties do not set the BSC Budget, this is done by the BSC Board, however without changes to the BSC Board, there is a risk that BSC parties could have higher costs imposed on them by the Non-BSC party board members who may have drivers to deliver other non-BSC objectives in pursuit of the commercial aspirations of the new subsidiary model. The contract model would allow BSC Co to determine the value of the contract and control its costs. We believe that both models require a change to the BSC Co Board.

d) Management distraction: In the subsidiary model, there is a risk that the commercial aspirations may be more exciting to Elexon management and its subsidiaries and so resources may be diverted to other non BSC work which will deliver a commercial return but may have a detrimental impact on performance of BSC obligations. Whereas, on the contract model, there will be more certainty of an income stream and investors which may allow Elexon to separately focus on delivery of the BSC and attracting new business.

e) Competitive Advantage: In terms of competitive advantage, without the ring fencing of the financial support for the DCC bid, other bidders may feel that the new Hold Co being funded by BSC parties could be seen to effectively underwrite their bid process for the DCC and yet that source of funds would not be available to other bidders.

f) Assets: We believe the assets of the BSC should remain with BSC Parties who have funded their procurement, development and maintenance. One of the remedies that BSC parties would have in the event that Elexon under a contract model failed to meet its obligations, or in the event of the failure of Hold Co, is that it would retain its assets and would make the transition to another service provider more straightforward.

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

The BSC Panel have obligations to ensure that they deliver the Balancing & Settlement Code objectives as laid down in the Code and the NGT licence. We do not foresee that this will change under the contract model. In a subsidiary model this may be more complex as the Panel will have no responsibility for budgets but will retain the obligation to sign off the BSC Co strategy, but the wider strategy of the new organisation will no longer be just the delivery of the BSC and may have other competing commercial drivers.

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. This will require a restructure and we have proposed a modification to introduce changes to the BSC Board.

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?

In the contract model – we believe it could remain as it is, however under the subsidiary model there would have to be strict separation between the regulatory obligations of BSC delivery and any commercial roles that the wider group.

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

No. We propose an alternative structure which would see BSC parties taking on more responsibility for the BSC and it would have the ability to appoint the right quality of expertise to support the contractual procurement processes.

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

In terms of the contract model we believe this is less of a risk than under the subsidiary model and so we would suggest that the step in rights should be retained for the subsidiary model but that they are unnecessary as the BSC Co Contract would have equivalent contractual provisions for non-performance, failure or regulatory change.

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

implementation challenges?

We would like to see an early decision on this that would allow parties certainty to get behind the chosen model and start to address the implementation issues that have been identified in Issue 40 and the Richard Morse report. We recognise that neither solution is a quick fix and each will have different challenges that need to be addressed.

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?

Yes: Parties have an understanding already of what it costs to deliver the BSC. Any contract awarded is likely to be based on those costs, plus any additional costs for procurement and contract management and that cost would be approved by the BSC Co Board (revised) and would only be in line with delivery of the BSC. Under the Subsidiary model the risk is that parties wouldn't have sight of the budget (as now0 and would have no transparency over the assignment of costs to the BSC parties, but would only have the ability via the Panel to approve the BSC strategy or not, with no view on how that fits with the overall ambitions of new Hold Co.

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?

Yes: we believe three is too short and ten is too long and would therefore support a five year initial contracting period.

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?

All assets provided by BSC parties should remain with BSC parties under BSC Co. ownership.

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?

A ring fence is absolutely essential. Without a ring fence we cannot be certain with regard to the risks we might face – financial or otherwise. What is not clear is how BSC Parties could have confidence that the ring fence is properly deployed and adhered to. When deadlines are tight or pressures are put on people, paper walls crumple.

Specifically, what are your views on?

a. The BSC Panel's ability to effectively hold Elexon to account under the subsidiary model?

The Panel have responsibility as defined in the code. While under the subsidiary model they could hold Elexon to account for the performance of the BSC services performed under the code, providing there were reporting requirements and Elexon was obligated to provide and account for its performance, it is unlikely that they would have any other power. Currently they are unable to determine the costs for the performance of the BSC and they will be unable to direct the use of resources or set priorities within Elexon's business such that relevant experts aren't being pulled onto other projects.

b. Whether enhancing NGET's licence to put new responsibilities on them in respect of any ring fence provision would be a suitable approach?

NGET's current role in terms of the administration and management of the BSC Co is relatively "light touch". They have non-voting role on the Panel and don't have any BSC Co Board responsibilities, and since there is no financial risk associated with the role are happy to undertake it in it current form.

c. Whether it would be better to do this through a new licence which would make Ofgem responsible for enforcement?

BSC Parties would need the reassurance that ring fencing was robust and appropriate and that there were remedies for any breach that were enforceable against the defaulting organisation. Parties would need to have confidence that the enforcement of ring fencing was impartial and fair and that they had a right of appeal in the event of a dispute. If the ultimate right of appeal for breach of ring fencing sat with Ofgem, they could not be the body responsible for enforcement, or if they took on the role of enforcer – where would any appeal sit?

Yours sincerely

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