Gemserv

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Rachel Fletcher
Ofgem
Acting Senior Partner, Distribution
9 Millbank
London, SW1P 3GE

Dear Rachel

**Open Letter Consultation: Potential expansion of the role of Elexon**

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Gemserv welcomes the opportunity to respond to the above consultation and supports the Ofgem initiative to undertake a review of the potential for Elexon to expand its role, ownership and governance arrangements.

Gemserv has a demonstrable background in developing and evolving processes and procedures to ensure markets work efficiently for all stakeholders. We have been at the forefront of evolutionary change in the energy, water and environmental sectors, working effectively both with and for participants, customers and industry regulators to develop best practice governance solutions. In our role at the centre of the energy sector and as an organisation set up specifically to facilitate a successful liberalised market, Gemserv has acquired extensive experience in the provision of robust and practical solutions utilising governance, process and market architecture expertise. These areas of competency are clearly at the centre of the debate on which this consultation seeks views.

Gemserv are uniquely placed to comment upon the future role of Elexon as we have an unparalleled historical understanding and experience as the only central body to have made the transition from Special Purpose Vehicle (SPV) to a fully fledged commercial organisation.

Through this response we have set out what we consider to be the key conditions and criteria upon which the industry should support the expansion of the role of Elexon. Elexon, like any other organisation, should be free to compete for contracts without any undue advantage or disadvantage from its current role in administering the Balancing and Settlement Code (BSC).

Accordingly we believe that the contractual approach best serves the BSC Parties, Elexon and the wider industry.

We have responded to those questions where we believe we can add most value and that we would be willing to discuss our thoughts on further and/or participate in any future groups.

Yours sincerely

K McRae

Ken McRae | Chief Operations Officer
Tel: +44 (0)20 7090 1012
Mob: +44 (0)77 3310 6504
Email: ken.mcrae@gemserv.com

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

We recognise that Elexon has extensive experience across settlement and, more widely, in the management of industry contracts. We support the diversification of Elexon's role which will enable these inherent skills and experiences to be more widely used by, and for the benefit of, the industry.

We concur that the history of the establishment of the Balancing and Settlement Code Company (BSCCo) did not predict an expansion of Elexon's role beyond the administration of the BSC and support the conditions associated with the protection and benefit of the BSC in light of potential expansion of Elexon's activities. The conditions set out in the open letter are an appropriate representation of the necessary balance between continuity of service and value for the BSC parties and facilitating the diversification of Elexon.

The first three conditions are key objectives for the BSC parties when considering that Elexon acts as the single BSC service provider, albeit with sub-contracts for some BSC services and systems. The fourth condition, whilst targeted specifically on the DCC competition, should in our view also apply to any non-BSC roles that Elexon bids for or secures.

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

In our experience, the contract model is the most effective means of delivering value and benefits to code parties. This is one of the reasons why MRASCo opted for a contracting model as it was considered inappropriate for a company (MRASCo) to be funded via a Licence condition on Distribution Licenses – Distribution Businesses were unwilling to fund activities which were not related to their core electricity function – e.g. services in the Gas sector.

A subsidiary model effectively means creating special purpose vehicles for each subsidiary. This approach could be adopted by a 'New Elexon' as a commercial choice under the contracting model, but the case for the BSCCo itself being such a subsidiary is less clear. Moreover, the contracting model has been adopted by other core industry documents, such as the MRA, Distribution and Connection Use of System Agreement (DCUSA) and Supply Point Administration Agreement (SPAA) and, to a lesser degree, the Uniform Network Code (UNC)/ Independent Gas Transporters (IGT) UNC. These examples provide a solid substantiation of the evolution and success of such arrangements and the breadth of useful experience that code parties have in managing appropriate contract terms and negotiations.

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Whilst we recognise that it is not necessary to mirror other models, equally there is no strong need to depart from them where they can demonstrably achieve the four conditions. In our view, the contracting model is the best fit for the BSCCo services, an approach that is corroborated by the procurement of delivery partners by Elexon in its current role as the BSCCo.

Under both models there is the issue of what the Articles of Association will look like and who will draft and subsequently agree them, this is in addition to agreeing all other corporate policies (e.g. dividend policy, dividend cover, levels of debt etc.) that are associated with the normal commercial running of an organisation.

The history of transforming the MRASCo services from an ‘in-house’ model to a contracted model may well provide useful insights in the considerations, and we would be pleased to provide Ofgem with more detail on the history of this transformation if this would be useful. For the purposes of this response, we have provided an overview in Box 1 below.

**Box 1: Contract model case study – MRASCo/ Gemserv history**

Since 1998 MRASCo had provided the MRA services 'in-house'. The experience gained by the MRASCo staff was considered to have potential benefits for other market codes and industry initiatives, but MRASCo was not permitted to undertake any business activity other than in relation to the MRA. A number of different models were considered, until in 2002, a contracting model was adopted in order to facilitate the wider use of MRASCo's expertise and skills.

~ Gemserv was established by seeking start-up capital from MRA parties, a total of £270k was raised (in the form of loan notes) with one initial share given to each MRA party. The loans were in proportion to the individual market share at that time and subject to the 66% / 33% split between suppliers and distributors respectively. Rather than a cash transaction, the loans were transferred as part of the reconciliation of the MRASCo budget, with the monies belonging to MRA parties not MRASCo.

~ Debt for equity swap in the form of shares was offered to the individual companies in proportion to the value of the loan notes (with a nominal number offered to those existing non-loan shareholders). Not all parties undertook the debt for equity swap, and at the same time additional shares were also offered to smaller suppliers.

~ MRASCo staff were transferred to Gemserv under TUPE regulations. MRASCo is a 'thin' organisation, outsourcing its corporate and MRA service functions.

~ A Service Agreement was developed, based on the services provided by MRASCo at that time, broken down into service areas with associated performance standards and price, the Service Agreement was also subject to independent review by Elexon. The pricing reflected the agreed MRASCo budget (agreed through the existing MRA process); that is MRA parties did not face any increase over and above the MRASCo budget.

~ The Service Agreement also has step-in provisions to allow the services to be taken back in-house and a Licence to Occupy was granted to Gemserv in terms of office space (50% contribution to premises cost).

~ The Industry (MRA parties) worked closely with MRASCo to develop and refine Gemserv's Articles of Association, with the Articles being closely modelled on MRASCo and, initially, on a 'not for profit' basis. The Articles of Association stipulate that only holders of an electricity supply or distribution licence can be a shareholder.

~ The objectives of MRA Executive Committee (MEC) were changed to allow it to contract out the MRA services.

~ The initial contract was awarded to Gemserv (for continuity of service) for a period of 3.5 years (the additional half year was to provide for the first expiry to coincide with the start of the MRA budget year). MRASCo is not obliged to appoint Gemserv as its service provider i.e. the relationship is subject to competitive pressures.

~ Cost incentives were achieved through inclusion of RPI-X indexation provisions.

~ A Services Agreement and Finance Expert Group (SAFEG) was established by MEC to develop and agree variations to the MRA Services Agreement. Its objectives are to:
    - Ensure that the Services Agreement continues to reflect the best balance of commercial requirements of MRA parties (via MRASCo) and Gemserv; and
    - Make recommendations to the MRASCo Board in relation to the annual accounts, accounting policies and procedures; appointment of the auditors and the auditors' report.

In 1998, when the MRA commenced, it cost approximately £10m p.a. (at today's prices) to run. For 2011/12, the annual MRA budget is £3.4m (excluding the operation of ECOES – an increased scope since 2006).

The contract model rightly places the BSCCo in the prime position to manage its contractual needs within the terms and duration of the relevant contract

In the following sections we provide our views on the merits of each option against the conditions set out in the open letter.

## Condition 1: BSC parties should not face higher costs

Either option will necessitate costs in setting up the appropriate corporate and organisational arrangements. It is arguable that, if the BSC parties support separation of the BSCCo from Elexon then the costs arising from that restructuring should be provided from the BSC budget. However, this would need transparent cost allocation between the BSCCo and 'New Elexon'/'Elexon HoldCo' shareholders to ensure the costs are proportionately allocated. Under the contract model, this cost to the BSCCo would be a one-off, whereas the subsidiary model could mean elements of this cost are repeated for each special purpose vehicle established under Elexon HoldCo.

The subsidiary model therefore is unlikely to prevent increased costs. Even with a 'not for profit' approach, there is still an initial outlay by each shareholder which is returned at a later date – in effect a 'dividend'. Under a contract model, cost savings are passed on to all users from the outset of each new contract term, enabling the benefit to be realised in a more contemporaneous manner for the 'paying' user community.

MRA parties have not faced higher costs as a result of the competitive nature of the contract model under which MRASCo operates, and we believe that a similar contract could deliver savings for the BSC parties over the medium term. The services which are delivered through the contract model are subject to competitive pressures and scrutiny, and have resulted in a reduction in running costs from approximately £10m p.a. (at today's prices) in 1998 to a now operational budget of £3.4m (2011/12, excluding the operation of ECOES).

Introducing a services contract regime between a 'client' and its 'provider' and integrating a profit margin, need not mean increased service costs. For example, when the contract underpinning the MRASCo Service Agreement was established, Gemserv committed at that time to the existing MRA budget that had been agreed by MRA parties, i.e. no additional provision to accommodate a profit margin. Cost incentives were built into the contract terms through RPI-X indexation provisions.

As we have observed previously in this response, it is unclear that the subsidiary model will ameliorate the recurrence of the costs associated with establishing additional special purpose subsidiaries.

Furthermore, it is unclear what incentives could be offered to investors in non-BSC activities in the absence of a return on that investment.

The case for the subsidiary model also raises additional considerations in terms of the actual costs of the ring-fencing arrangements. By way of example, the undertakings regime operated by BT in the telecommunications sector is a burden on the operating organisation. We do not think that the business costs, regulatory burden and commercial flexibility impacts have been fully considered at this time to demonstrate that this model has the same agility as a contract model to achieve the optimum compliance with this condition.

We would further observe that Ofgem have recently issued an open letter in respect of a review of Xoserve[1]. The issues identified in that document are partly due to hard-wiring service provision requirements into a 'codified' service provider organisation. As we noted in our response to that open letter, there is no issue with the standard of service provided by Xoserve, rather that the construct of the code contract is perceived to frustrate market-led development.

On balance, we consider that the contract model examples in use today in the energy sector have demonstrated that operational costs can be driven down through appropriate efficiency and performance clauses within a contract. It is acknowledged that both models will entail cost, however, we are of the view that implementing a contract model will provide the right environment for BSC parties to define and select the services they require to be delivered by the BSCCo.

A factor when considering the cost impacts would also be whether the BSCCo would be a 'thin' organisation, or whether that organisation would seek to operate some services in-house. This is a matter for BSC parties to consider, although we would observe that, in the event the BSC parties opted for a 'thicker' BSCCo, this might incur greater costs than the current model.

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

The transformation to facilitate the expansion of Elexon, whether through a subsidiary or contract approach, will introduce a risk that is not material under the current arrangements, whereby Elexon is the BSCCo.

[1] Ofgem Open Letter consultation: Review of Xoserve dated 19th September 2011

However, there are examples of step-in and transfer back contract conditions in a number of commercially procured services of a similar size to, if not larger than, the BSC arrangements. As the open letter notes, this risk prevails through either of the options.

Risk, by its nature, requires contingency and an appropriate risk premium. In terms of either providing the BSCCo services through a contracting or subsidiary model, this risk is not significant if the initial contract/ special purpose subsidiary resides with Elexon. However, taking into account the aspiration to enable Elexon to compete for the DCC licence, the risk profile changes significantly. Not only is the DCC role integral to the day to day operation of energy companies, it will be taking contractual responsibility for service providers delivering critical aspects of the new market arrangements.

Taking the above into account, embedding a DCC subsidiary under an Elexon HoldCo, which is also responsible for the continuity of the BSCCo services, is a major undertaking on a scale that could be considered as a critical risk on BSC parties. For example, under extreme conditions, there would be a requirement upon the shareholders of the Elexon HoldCo to keep the DCC subsidiary solvent in order to fulfill its step-in/ managed exit obligations. Any synergy in service provision benefits would likely be compromised in such an event, with detriment falling either to the BSCCo or DCC services.

We therefore consider that the most appropriate vehicle to enable Elexon to participate in the wider market, including DCC, is for its diversification to be managed through contractual separation. We further support this view with the expectation that the contract model can provide the appropriate legal recourse for failure, which a subsidiary model could not deliver without a gold standard guarantee from Elexon HoldCo.

In seeking to expand, Elexon should act as a commercial company without a continuing entitlement flowing from the current arrangements to perform the BSC activities. Moreover, the creation of subsidiaries to manage the various non-BSC contracts will create a multiplicity of managing boards which will have different – and potentially conflicting – responsibilities, which exposes the BSC parties to an additional risk.

On balance, we consider the risk mitigation should be within the control of the BSCCo itself, rather than Elexon HoldCo. We recognise that this may require the BSCCo Board to operate in a manner that it has hitherto not contemplated whilst Elexon has acted as its executive. However, given that there is an expectation that the BSCCo services contract will be delivered by Elexon in the immediate term, this risk is ameliorated by the continuity of Elexon's involvement. It may be necessary for the initial contract to consider provisions for the knowledge transfer and orderly handover of some of the critical contract management aspects of the BSCCo duties.

It would be expected that BSC parties would consider whether the BSCCo should operate as a thin organisation, or whether it would seek to undertake some activities in-house. This could introduce an additional risk, although this can be mitigated by the contract covering support from Elexon for certain BSCCo activities throughout the term of the initial contract. In this regard, it would be expected that identification of critical staff (whether under a subsidiary or contracting model) would be undertaken prior to the transformation. We also note that a modification proposal has recently been raised by a BSC party in respect of revising the make-up of the BSCCo Board in anticipation of the unbundling of Elexon from the BSCCo.

## Condition 3: Standards of service should be maintained

The existing service levels provide a relevant benchmark when considering the handover to either the subsidiary or contracted model. However, these should only be considered as legacy service levels or Key Performance Indicators (KPIs), and should be capable of flexing to demand-led needs.

Either model should be capable of evolving the standards of service, although we would note that the single service provider model (in the energy and other utility sectors) has often been slow to respond to market-led changes. This has led to perceived barriers in market participation, which would be an unfortunate consequence of any transformation of the Elexon/ BSCCo arrangements.

Commencement of either the subsidiary model, or contract model, with Elexon being the first contracted service provider, should be capable of securing the maintenance of service standards in the short term. However, it is the evolution of the new Elexon model that could impact the continuity of service capability. The BSC places a volume of obligations on BSC parties and their agents to meet performance standards and it is unlikely to be acceptable to those parties for the revised BSCCo delivery model to under-perform in comparison to current KPIs.

We believe that the current service standards are appropriate for the existing arrangements, and should be replicated in any future service lines or measures. However Ofgem's aspiration for smarter markets should not be constrained by enshrining any such service expectations within the articles of a special purpose vehicle or a long-term contract.

Provisions for negotiable variations are a key factor in service standards – not only from the perspective of the BSC parties, but also in the shared journey of market evolution. BSC parties will need service continuity, just as a service provider will, regardless of the service provision model. In our experience, a negotiable contract with appropriate variation provisions is an appropriate vehicle. Moreover, where a contract has multi-lateral users and a rights and responsibilities matrix, we believe inclusive stakeholder involvement is key to delivering the optimum service for all users. A contract model offers the better ability to achieve this, although a subsidiary model might achieve it with the appropriate level of corporate flexibility.

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

We concur with the view expressed in the open letter that use of BSC funding to support any non-BSC related activity is inappropriate.

The selection of the Data Communications Company (DCC) licensee is not within the remit of BSC parties and, consequently, any preference by any BSC party in advancing the case for Elexon should not be capable of being construed as unduly influencing the competitive licence application process.

The subsidiary model might provide a degree of mitigation against such advantage, although it arguably remains open to challenge by interested parties who are not similarly served by energy-sector specific arrangements. However, this has to be considered in light of the primary objective of the open letter in regard to future DCC activities by Elexon. The DCC role is expected to expand within the Smart Metering Implementation Plan (SMIP) objectives as well as Ofgem's 'Smarter Markets' vision. There is the potential for conflicts between the DCC role and the BSCCo responsibilities under the subsidiary model that could be complex to deconstruct in a future scenario, which would be an undesirable consequence of the subsidiary model.

It should also be noted that this specific condition relates to the timing of the proposed changes e.g. it is being undertaken now in order for Elexon to be able to bid for the DCC – however, and importantly, the DCC procurement timetable should not result in a less than robust process for Elexon's transformation.

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

The primary function of the BSC Panel should be the operation of the BSC, however as noted above, it may need closer scrutiny of Elexon if a contract model followed and greater transparency if a subsidiary model transpired to ensure core services continue to be provided to time, quality and on budget. The approach used by the MRA Executive Committee is shown below in Box 2.

**Box 2 SAFEG**

The MRA Executive Committee established a Services Agreement and Finance Group (SAFEG) to provide expertise in managing the Services Agreement and contracted funding. The objectives of the Group are to ensure that the Services Agreement continues to reflect the best balance of commercial requirements of MRA parties (via MRASCo); and to make recommendations to the MRASCo Board in relation to the annual accounts, accounting policies and procedures; and appointment of the auditors and the auditors' report.

At the time of the transformation of the MRASCo services to a contract model, the key change to the MRA was to amend the objectives of the MRA Executive Committee to include responsibilities in respect of procurement of the MRASCo services through a Services Agreement and managing variations and terminations to that Agreement. This included the assignment/ leasing/ licensing of MRASCo property, rights and liabilities to the third party contractor.

It is important to note that there was no substantive amendment to the MRA duties and responsibilities fulfilled by MRASCo, rather that these activities would be procured through a Services Agreement.

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

There should, under either model, be provisions for the continuity of services either by a right of step-in or through an orderly transfer to an alternative service provider. The continuity of a quality and efficient service to the BSC parties has to be the overriding objective in the event of breach of contract or company failure.

The Services Agreement provides for MRASCo to transfer Gemserv staff who have been involved in the delivery of the MRA services, if requested, in the event of termination due to a breach of performance failure. This also includes a requirement for the contractor to novate or assign any leases or contracts and to sell hardware or equipment to MRASCo at a fair price.

## 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?

We agree with the assessment made that the contract model could provide a robust and straightforward solution that provides both confidence to BSC and other parties, and clarity in terms of costs associated with new activities.

It is clear that there are concerns when a new subsidiary is established under a holding company to initiate new activities.

When Gemserv was established it was agreed that start-up capital for the service company would need to be found, with a total of £270k raised from MRA parties. Gemserv believes that the most straightforward and proven method (from its own experience) to provide confidence around subsidization of new activities is to operate under the contract model, with equity or loan capital in place to support the development of new business activities for which a rate of return might be expected.

### 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?

We do consider that it is viable to create a contract on an 'as is' basis and this should be the approach to ensure that conditions 1 to 3 can be achieved. A departure from this approach could either expose the BSCCo to more risk, or risk of scope creep to New Elexon. Gemserv was established on an 'as-is' basis and had a 3.5 year contract, which has now been replaced by a 5 year contract.

The length of contract needs to ensure that it satisfies and enables conditions 1 to 3 to be achieved. Gemserv believes that a contract length in the region of 3 – 4 years would be appropriate and strike the right balance between continuity of service and competitive pressures. If a contract length is too short then the contracted party can be distracted from quality delivery by the pending tender process, also a short contract length would present challenges in term of the DCC procurement timetable. If a contract is too long then the lack of an imminent competitive pressure can result in poor service levels and low innovation within the contract.

### 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?

The retention and or transfer of assets may depend on the current construct of any contracts, leases, licences and the like, and could require separate transfer agreements or even licence to occupy. Another factor will be the treatment of any liabilities attached or accruing from any assets. For example, Gemserv originally contributed 50% of premises costs to MRASCo, subsequently any liabilities for premises now resides wholly with Gemserv.

We would be pleased to provide Ofgem with historical information on the transfer and licensing of MRASCo assets, and liabilities to Gemserv and how that changed over time if that would help inform their considerations on this aspect.

### 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?

Firstly, we believe the contract model has a better track record of achieving continual improvement and value for money. It is impossible to replicate the competitive pressures through requirements and SLAs; this will always be a poor proxy for the real threat that the business may be lost to a competitor. This threat will fundamentally change the mindset of the service provider – they will focus on cost efficiency and quality of service as demonstrated by Gemserv's provision of MRA services.

With regard to cost efficiency, Gemserv has adopted an RPI-X approach with MRASCo. RPI-X is a well established pricing mechanism that has delivered investment and improvements across the industry. This mechanism coupled with the appropriate contract length, clearly defined service levels, an obligation to innovate, continual service improvement KPIs, provision for benefit sharing, and penalties for failure within the contract will ensure that performance, service levels and value for money are achieved.

### 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 will provide a level of safeguard. However, such arrangements place additional burdens and regulatory requirements on the BSCCo subsidiary than those that exist under the present arrangements.

As we have noted elsewhere in this response, there are examples of such ring fencing arrangements on a single service provider in other sectors and these have not removed the perception that the service is dedicated to its parent rather than its users. This in turn created a large compliance enterprise within the parent and subsidiary, which in itself created additional cost.

Since these ring fencing provisions can largely be avoided through adopting the contract model, the rationale for the subsidiary approach is diminished.

### Specifically, what are your views on:

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

We consider that there are complexities in managing accountability under the subsidiary model. For instance, Ofgem note a requirement for separate management structure between the Elexon HoldCo and its subsidiaries. This places a distance between Elexon and the BSCCo subsidiary which could compromise the ability to effectively hold Elexon to account.

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

This may be a solution; however it needs more examination in terms of the role of NGET in Elexon HoldCo and potentially any of its subsidiaries.

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

As above, this may be a solution, but it is a material shift from the current arrangements. It may be something that could be considered in the future, but we would observe that the contract model can be adopted without such a transformation of the licensing arrangements for the BSC. Moreover, the contracting model may well serve to support any future change to the licensing arrangement, for example providing similar procurement requirements as applied to the DCC licence.