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Dear Rachel,

POTENTIAL EXPANSION OF THE ROLE OF ELEXON

Thank you for this opportunity to respond to your open letter consultation on the potential expansion of Elexon's role to allow it to participate in the competition to be the smart metering Data Communications Company (DCC).

We would encourage all suitably qualified parties to participate in the DCC competition, as this should help ensure the best possible outcome from that process. Accordingly, in principle we have no objection to Elexon participating, so long as this can be achieved in a manner which does not detract from the performance and governance of its BSC duties or increase their costs. In saying this we would emphasise that we are offering no view at this stage as to Elexon's potential suitability for the DCC role.

Ensuring there is no detriment in the areas of cost, performance and governance will be key to any proposal to allow Elexon to proceed. We agree with Ofgem that simply allowing the BSCCo to engage in non-BSC activities does not meet these objectives. Therefore, we think that only an approach that effectively separates Elexon from the BSCCo should be considered.

We do not endorse the "Subsidiary Model". We do not think that a BSCCo that is a subsidiary of Elexon could have sufficient independence from Elexon, even if it had separate Board membership. The holding company would inevitably have controls over many aspects of the subsidiary which could compromise its independence. BSCCo, which is intended to facilitate balancing and settlement in a manner which gains the full confidence of the industry, would cease to be owned by NGET and instead belong to the outside investors owning Elexon Holdco.

There is also the question of asset ownership and we would suggest that any assets purchased by Elexon should revert to the ownership of BSC Parties in the event of any separation or else be sold to Elexon. Naturally, this would include any IT hardware or software, buildings, contents and any intellectual property. Also while Elexon might view the knowledge of its employees to be its principal asset towards realising its ambitions, we take the view that any data repository Elexon currently manages should similarly remain an asset of the BSC.

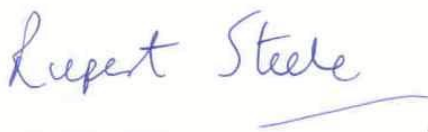
Another complication could arise from the further development of the Smart Energy Code (SEC) in that the DCC might be required to accede to a number of other industry codes, including the BSC. As the BSC currently excludes the BSCCo from accession, this might present a technical challenge to the Subsidiary Model.

By contrast, we think the "Contract Model" could be made to work. By separating Elexon from the BSCCo role, Elexon could be permitted to pursue other business. However, there are a number of limitations and caveats:

- The contract between BSCCo and Elexon would need to contain strong safeguards to ensure that Elexon did not discriminate between BSC parties, especially if any individual parties were its shareholders or customers;
- BSC Parties should not be liable in any way for the setting up of Elexon's new venture, although costs directly associated with establishing the BSCCo as the procuring entity and with procuring the BSC code administrator would naturally fall to BSC Parties. This is necessary to insulate BSC Parties from any potential liabilities which could be incurred by an Elexon operating in a wider role;
- Clarity would be needed on who can invest in a commercially structured Elexon. In particular, DECC recently consulted on the extent to which DCC users could own any holding in the DCC. Although the Government's position is not yet known, BSC Parties might hesitate to invest in the venture while this question remains unanswered;
- There would need to be complete legal separation of Elexon from BSCCo. The assumption of Elexon as the BSCCo would, therefore, no longer be enshrined in the code itself and instead, a new role of 'BSC Code Administrator' would be introduced and made subject to re-procurement on, say, a triennial basis. This new role would perform the functions currently performed by Elexon, but on behalf of the BSCCo. The BSCCo itself should not be subject to re-procurement;
- Elexon would need to maintain existing charges for BSC services or reduce them, taking any profit margin from efficiency gains it can achieve.
- Arrangements will also be needed to ensure that a third party is able to step in and assume the BSC Code Administrator role and provide service continuity in the event that Elexon runs into difficulties elsewhere in its business.

Our responses to your specific questions are included below as an appendix. Should you wish to discuss any areas of our responses in more detail, please do not hesitate to contact me.

Yours sincerely,



Rupert Steele
Director of Regulation

Specific Responses

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

We are broadly supportive of the views expressed in the consultation document.

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

Please provide reasons.

We do not believe the 'Subsidiary Model' is worthy of further consideration and would, instead recommend focusing all attention on the 'Contract Model'.

If a 'New Elexon' is to take its place in the market, we think it important that it is subject to the same competitive tensions as any other market participant. We also, therefore, agree that the role of BSC Code Administrator should be submitted to regular competitive re-procurement process.

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

No. We consider the role of the BSC Panel to be entirely insulated from changes to Elexon's articles of incorporation.

Nonetheless, in such circumstances, we believe it would be appropriate for the role of the BSC Secretariat to be separated, both physically and legally, from the role of BSC Code Administrator, such that the BSCCo assumes all responsibility for the secretarial activity, including the role of Panel Secretary. Meanwhile a competitive tender exercise should be conducted to secure the services of a Code Administrator; of course, recognising that it may be more expedient to simply continue with Elexon in the administrator role in the short term.

4. Would the current arrangements for the BSCCo Board allow it to fulfil any additional responsibilities and mitigate any risks associated with the expansion of Elexon's role?

No. The BSC arrangements, as currently interpreted, make no distinction between Elexon and the BSCCo, such that the board of the BSCCo, to all intents and purposes, is also the board of Elexon, and vice versa. Under the envisaged Contract Model arrangements, we consider it neither appropriate nor practical for the BSCCo board to continue in this dual role.

Although the Code of Corporate Governance (formerly the Combined Code) recommends that boards - and particularly boards in the commercial sector - be constituted of both executive and non-executive members, the board of the BSCCo has always had an entirely non-executive membership. Indeed, the industry has historically resisted attempts to allow the appointment of Elexon's CEO and/or CFO to the board.

In our view, under the Contract Model, Elexon should create an entirely new board, which is quite separate from the BSCCo board, and should be constituted of both executive and non-executive members. We would not consider it appropriate for BSCCo board members to also serve of the New Elexon 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?

No. In our view both the NGET licence obligations and the approach to discharging them through the BSCCo have worked very well to date.

In principle, while we do not believe that moving to the Contract Model will have any significant impact on these arrangements, we recognise that there will doubtless be a number of legal technical difficulties to surmount before the transition can take place (e.g. resolving NGET's ownership of Elexon etc.)

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 do not believe the BSC Board to be appropriately constituted and resourced to deliver such an enhanced role. We do, however, consider the Board to be suitably constituted to satisfy its role with regard to the BSCCo in the event that the BSCCo and Elexon become legally separate entities.

While the Board has made final decisions over procurements in the past, it has always placed considerable reliance on Elexon's procurement team to act on its behalf in conducting contract negotiations and making recommendations. While it may yet be appropriate for the 'New Elexon' to provide this service as part of its contracted obligations in other areas, it would represent a clear conflict of interest were it to act in a similar capacity in a future re-procurement of the BSC Code Administrator. Therefore, as the licence obligation to establish a Code Administrator rests with NGET, it may be more appropriate for NGET's own procurement function to support the BSCCo Board at such times (we note that the stipulation is to establish a secretarial or administrative body).

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

Yes. We consider it vital to ensuring the continuity of the BSC arrangements, and the services provided under those arrangements, that BSCCo retains a right of 'step-in'. However, recognising the need to also protect the rights of investors in the 'New Elexon', we would suggest that the right of step-in must only be exercised in particular circumstances and that these circumstances (e.g. performance issues, force majeure etc.) should be clearly set out in the BSC.

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

In our view, the greater challenges to implementation would be faced with the Subsidiary Model, but we have concluded that this model should be rejected for the reasons set out in our covering letter and summarised below:

- it risks BSC Parties incurring costs arising from the failure of Elexon Holding Company (which might, in turn, have arisen from stress in other areas of Elexon's holdings);
- it lacks obvious incentives to deliver the best value to BSC Parties, as the Elexon Holding Company would be the ultimate controller of BSCCo;
- it is too complex; and
- it creates a primary role for Elexon, which should be the preserve of licensed entities;

Turning our attention to the Contract Model, we would consider it appropriate to novate the Warm Homes contract to 'New Elexon'. Elexon Clear Limited, on the other hand, should be renamed BSCCo Clear Limited, as its ownership must be retained within the BSCCo structure.

While the principles of the contract model need to be fully understood before allowing Elexon to bid for the DCC contract, it is not clear whether they need to be implemented (with the associated overheads) unless the bid progresses to a sufficient stage in the selection process

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. We consider this to be the most effective of the models proposed and the only one to offers sufficient separation to insulate BSC Parties from any additional costs.

Furthermore, while we accept that the 'departure' of Elexon from its current role will result in some minor, if inconvenient, costs to BSC Parties, we believe it is appropriate that 'New Elexon' and its investors absorb the entire costs of embarking on this new venture.

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. At minimum, a contract based on "as is" service levels ought to afford reasonable protection to the existing services. We think that there should be no increase in prices and that any profit margin should be achieved by New Elexon making efficiency savings.

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?

We believe that all fixed assets should be retained by the BSCCo, including all buildings and IT systems etc. Naturally, any intellectual property should also remain the property of BSCCo, although much of the documentation will need to be rebadged to avoid confusion and/or the potential for future legal dispute in this regard. Also, contracts (e.g. with service providers, landlords etc.) will need to be revisited to ensure the contracts are with BSCCo and not Elexon.

In considering assets, one should also contemplate responsibility for any liabilities. In this case, we would anticipate that any liabilities that would naturally be considered BSC liabilities (along with other financial aspects, such as depreciation of assets) will remain the ultimate responsibility of BSC Parties. Conversely, liabilities arising from any contracts that Elexon might enter / have entered into on its own behalf, such as Warm Homes (see our response to question 8), should remain the responsibility of Elexon.

An alternative structure could see a greater part of the fixed assets transfer to Elexon in return for appropriate payment to BSCCo and subject to covenants intended to guarantee the effectiveness of step-in rights.

12. If the contract model is adopted, what approach do you consider most suitable for ensuring that incentives exist for performance, that service levels are sufficiently defined and secured, and that value for money achieved?

As Elexon would become, in effect, another BSC Agent, we would consider the requirements set out in the BSC and in the Code Subsidiary Documents to represent the

scope of the service required from the Code Administrator. This would require the addition of a new Service Definition Document to the existing suite.

Thereafter, it is for the BSC Panel to police the quality of the service provided by the contracted agent and to escalate performance issues to the BSCCo Board for action as necessary.

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 or enforcement?**

On balance, while we believe the Subsidiary Model could offer some technical refuge from costs arising from the failure of 'New Elexon', we still believe it represents unacceptable risks to BSC Parties because: -

- a) We do not consider the Subsidiary Model offers any real scope for the BSC Panel to hold an underperforming Elexon to account, as it effectively enshrines Elexon in the role as the BSC Code Administrator.
- b) It would be inappropriate to place further licence obligations on NGET where the obligations relate to an organisation over which it can exercise little if any control.
- c) We do not see that a new category of licence is a necessary or proportionate step. There are many medium sized bodies playing vital roles in the UK energy system and a separate licence category for each would be excessive. The arrangements as they stand have worked reasonably well over the years since NETA/BETTA and the disruption caused by a change to the licensing framework is not needed in order to protect the position of BSCCo.