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Dear Rachel,

***Open letter consultation: Potential expansion of the role of Elexon***

SSE is pleased to provide comment on the above consultation. We have provided further comments in relation to the questions posed by Ofgem within the attached appendix.

SSE agrees with Ofgem that synergies do exist between the process currently being run by Elexon and the anticipated role of the DCC and the potential for cost savings from the more efficient use of its fixed assets and other resources. However, this is subject to the issues being highlighted within Ofgem's consultation document being addressed, in particular the key conditions specified must be met, e.g. BSC Parties should not be compelled to provide investment capital for business start-up and growth opportunities. SSE is also in agreement with Ofgem that any proposed bid from Elexon to become DCC must not put the BSC arrangements at risk.

As a result, should Elexon's role expand, SSE would advocate the contract model ahead of the subsidiary model. We believe that this provides a more transparent and effective way forward to resolve the issues, given the balance of the 'pros' and 'cons' identified with each model by Ofgem and previously by the Issue 40 Group. On balance, and for the avoidance of doubt, SSE does not believe that the current incremental, "bolt-on" approach remains appropriate for an expanded Elexon as the BSC will soon become unwieldy and cluttered with rules, rights and liabilities which have nothing to do with wholesale energy balancing settlement, e.g. Warm Home Discount Reconciliation.

The subsidiary model, whilst capping liability risk significantly increases other risks (such as that of asset sales / reallocation or reprioritisation and administration), is too opaque and the fear is that Elexon will cross-subsidise in its allocation of costs in this model (i.e. using the BSC to fund a disproportionate amount of Elexon's assets / costs etc, in order to maximise the 'competitiveness' / 'profitability' of the DCC or other non BSC activities, in particular allocation of people's time becomes very difficult to separate effectively in this model).



We would therefore support the implementation of Option 2 and the separating the BSCCo entirely from Elexon and establishing a (leasing) 'thick' contract between the BSCCo and Elexon (the contract model), with Elexon as the service provider and BSCCo as the service procurer and owner of the existing (and future) BSC intellectual property rights and assets. Possible ring-fencing provisions within the DCC's licence may also prevent Elexon from becoming DCC if the BSCCo was allowed to undertake non-BSC activities.

SSE believes the contract model to be more transparent and robust than the subsidiary model however, this must rely on the contract containing sufficient provisions to ensure the protection of BSC activities. The contract must be based on the (leasing) 'thick' approach so as to ensure the protection of all BSC activities should Elexon become insolvent or consistently fail to deliver expected standards, due to its non BSC related activities failing.

We believe a (leasing) 'thick' contract should take the form of BSCCo retaining the ownership of all existing assets<sup>1</sup> and core functionality 'in-house' and leasing these to Elexon (Ofgem has given consideration to this option on page 8 of the appendix). This approach would provide the most obvious means of assuring (BSC) business continuity in the event that any other element of Elexon's activities should fail and subsequently fall into administration. By ensuring that the correct provisions were included within the leasing contract, should Elexon fail as the DCC, then an administrator of Elexon would be unable to sell off the BSC assets (as these would be leased from BSCCo, who would retain ownership) thus allowing the continuation of BSC activities with the minimum of disruption.

A further advantage of the leasing contract approach is that BSCCo can seek competitive tenders (for the lease) from other service providers, including those seeking to be DCC, who might wish to offer similar synergy benefits that Elexon believes are realisable from jointly 'operating' certain BSC and DCC functions. This approach would have two distinct benefits; (i) introducing competition to the Elexon bid for the BSCCo leasing contract and (ii) improving competition in the DCC tender process by allowing others (besides Elexon) to realise the synergy benefits of undertaking both BSC and DCC functions.

Whilst SSE agrees with Ofgem that, *'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.'* Despite this, we believe this is a worthwhile exercise in order to ensure the security of BSC arrangements. To this end we believe that to take this matter forward, of the four options identified in your letter (on page eight), that the third option "a *specialty convened committee, drawn from BSC Parties*" is the most appropriate way to proceed, whilst recognising that such a committee may need "to *procure advice and expertise*" (as noted in the second option).

Please call me if you have any questions

Yours sincerely

Steven Findlay

**Regulation**

Cont.

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<sup>1</sup> All existing assets (including intellectual property rights) associated with BSCCo **and** Elexon have been paid for entirely and exclusively by BSC Parties. None of these existing assets should be transferred to 'new' Elexon except via a lease whereby the asset ownership continues to reside, via BSCCo, with all BSC Parties.

## Appendix

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

Yes, SSE strongly agrees with the conditions Ofgem has considered within the consultation document.

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

SSE believes that a (leasing) 'thick' leasing contract model would better meet Ofgem's conditions. As stated within our covering letter, in order to ensure that the four conditions are met, Ofgem should introduce the leasing contract model as this would reduce the risk faced by BSC Parties.

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

SSE considers that the role of the BSC Panel should remain in its current state through its relationship with BSCCo. However, should the contract model be adopted, the BSC Panel should be given increased oversight of contract management and the terms within that contract (subject to those terms not being confidential) to provide assurance and satisfaction to BSC Parties that services are being delivered in an efficient and robust manner.

### **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, SSE does not believe that the current arrangements are suitable going forward. We believe that industry should be given more status within the BSCCo Board in order to provide closer management of funding from BSC Parties. Our view is aligned to that of BSC modification proposal P281<sup>2</sup> which will allow BSC Parties to have a more active say in oversight and management of the BSCCo

### **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?**

Yes, subject to the leasing contract model being adopted, SSE does not believe that it would be essential to oblige National Grid to ensure the BSC document is in place through a licence condition, nor own BSCCo. Adopting the leasing contract model would allow the resultant contract to be drafted in such a way that would allow 'step-in' rights for all BSC Parties in the event of a service provider failure, along with provisions in the BSC itself that obliges BSC Parties, through BSCCo, to do so. As all BSC Parties realise a significant collective benefit from centralised arrangements for balancing and imbalance settlement, given the nature of the commodity, so it is within their interests to ensure its continuation

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

We believe that the BSCCo Board could benefit from additional resources to enhance its ability in terms of contract negotiation etc, with service providers. As mentioned in our response to question four, we note that Modification P281 has recently been raised which appears, on initial examination, to offer a potential solution to the BSCCo Board arrangements.

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<sup>2</sup> <http://www.elexon.co.uk/Pages/P281.aspx>

SSE would suggest that industry could undertake contractual negotiations to ensure these are sufficiently drafted. This should be done through an Industry Project Board (along similar lines to that used when NETA / BSCCo et al was being established) which could support the drafting exercise by undertaking this using 'in-house' industry expertise or appointing the relevant external advisors or a combination of the two. In terms of the both the contract negotiations and approvals / signatures of the final contract(s), the BSCCo Directors, including the Chairman, will need to be (and act) independent from the Directors and Chairman of Elexon in order to avoid any potential conflict of interest and to ensure compliance with corporate governance 'good practice'.

In our response to question five we highlight significant changes to the governance arrangements of the BSC and we believe this should be reflected within the BSCCo Board structure. The current BSCCo Board structure does not provide enough stakeholder oversight and control over BSCCo financial and other corporate decisions (despite being funded by BSC Parties). This should be rectified going forward.

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

Yes, in order to ensure continuing levels of service the BSCCo should be given a right of 'step in'. If a service provider is continually failing to provide the agreed service levels the BSCCo should be able to intervene, either through contractual agreements or BSC provisions. In this regard the leasing contract approach offers the best 'step in' capability for BSCCo as the asset ownership etc, resides with BSCCo and not with the service provider (who could (i) sell the assets on and / or (ii) 'reallocate' or 'reprioritise' them to other more profitable – from Elexon's perspective – contracts with other companies).

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

Whilst SSE appreciates that this would be a resource intensive project for industry, engaging fully with industry participants is vital to ensuring the leasing contract is drafted sufficiently to cover all the relevant factors and setting up an Industry Project Board to oversee this process will also be required. A similar approach was adopted when BETTA and NETA were introduced.

However, whilst recognising the desire to meet DCC bidding timescales, SSE believes that this project should not be driven solely by Elexon's desire to become DCC as there is a danger that short cuts are taken in attempting to meet this ambition that introduce significant risks and exposures to BSC Parties. This project should be delivered on a timescale relative to the amount of change required in order to ensure the new BSCCo arrangements are fit for purpose.

#### **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, but as we have stated within our covering letter, whilst we agree the contract model to be the best way of ensuring BSC Parties face reduced risk, SSE believes that for the contract model to be more transparent this must rely on it containing sufficient provisions to ensure the protection of BSC activities. The contract must be 'thick' as to ensure the protection of BSC activities should Elexon be brought into administration.

In this regard we believe that a leasing contract approach is the most appropriate way to proceed as it maximises competition (for both the service provision to BSCCo and the DCC) whilst minimising the risk to BSCCo and BSC Parties. Whilst we do not necessarily envisage it, if there is as a consequence of this approach an increase in risk to the expanded Elexon

then Elexon will have to bear that risk, we should not be seeking to minimise the risk for Elexon expansion at the expense of increased risk for BSCCo (and BSC Parties who stand behind BSCCo). BSCCo cannot be allowed to fail – as the GB electricity market would be severely compromised – unlike ‘new’ Elexon. Given this it is entirely appropriate to seek to minimise the risk(s) for BSCCo.

**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?**

SSE notes that Ofgem has referred to a period of three years within their open letter. This seems sensible and pragmatic as it would allow ‘new’ Elexon to tender for both the BSCCo and DCC activities whilst allowing BSCCo not to be locked into a long term contract where, if Elexon fails to win the DCC tender, the DCC service provider might, in three years time, offer a more competitive contract to BSCCo than Elexon. Whilst there maybe benefits in a longer term contract, we see that the primary beneficiary of the ten years suggested at Ofgem’s meeting on the 8<sup>th</sup> December 2012 would be Elexon and the party who would have most to lose would be BSCCo. We therefore do not support such a long term contract. We may be prepared to accept a 5 year period if a 3 year term is considered insufficiently bankable to secure financial investment.

**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?**

As stated within our covering letter, we believe all the existing BSCCo and Elexon assets should remain with the BSCCo, in particular the Intellectual Property Rights (IPR) and all personnel etc, required to efficiently operate the BSC contract. For the avoidance of doubt we would expect this to cover most existing (Elexon) staff with the exception of particular development and senior management roles.

This approach would provide the most obvious means of assuring (BSC) business continuity in the event that any other element of Elexon’s future activities should fail and subsequently fall into administration. By ensuring that the correct provisions were included within the leasing contract, should Elexon fail as the DCC (or any other activities Elexon chooses to take on in the future), then an administrator would have to allow the continuation of BSC activities as the (BSC) assets would be owned by BSCCo, rather than Elexon, so these could not be sold off by the (Elexon) administrator.

**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?**

SSE would advocate that the model currently adopted for the Supply Point Administration Agreement (SPAA). The contract between SPAA and service providers contains a number of Key Performance Indicators (KPIs) and Service Level Agreements (SLAs). Any failure to meet these standards are then escalated to the SPAA Executive who decides what remedial action is required.

SSE would suggest that a similar approach is taken for the contract between BSCCo and Elexon. The SPAA provides a basis upon which to agree KPIs and SLAs that should apply to Elexon (as the provider of BSC services). This SPAA<sup>3</sup> experience coupled with the existing provisions of the BSC (including the associated procedures etc) and the current (BSC) KPIs should, in our view, allow the Industry Project Board (see Q6 and Q8) to use these as a starting point for developing the equivalent (BSC) SLAs and KPIs that Elexon will, contractually, be required to comply with and report performance against.

<sup>3</sup> Or any other relevant service provision contractual performance knowledge and experience.

Given the synergy benefits between BSCCo and DCC, the subsequent DCC Licensee (or service providers) may be able to provide a more competitive offering than that currently being provided by Elexon as discussed in our response to question 11.

### **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:**

Please note, SSE does not support the subsidiary model for the reasons we have outlined previously within this response.

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

The ability of the BSC Panel to hold Elexon to account would, in a subsidiary model, be very limited. There is a serious risk that senior Elexon personnel decline to engage with the BSC Panel either (i) on an ongoing, day-to-day, basis and / or (ii) at times when the provision of service(s) is being called into question by the BSC Panel.

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

As noted in our response to question five, given the critical role of the BSC in the ongoing functioning of the GB electricity market there is a strong case (with the subsidiary model) for enhancing NGET's licence to ensure that the BSC will continue in all eventualities and this is especially the case with the subsidiary model (where the risk of a failure threatening the ongoing operation of the BSC is at its highest).

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

Yes, however Ofgem would need to be satisfied that they have sufficient resources to manage the enforcement of any new licence. Ofgem will need to be heavily involved in the ongoing management of the BSCCo in order to ensure that BSCCo ensures that the service provider (Elexon) meets ongoing KPIs and SLAs.