

## ELEXON RESTRUCTURING NOTE

### A. CREATING AN EFFECTIVE RING FENCE UNDER THE SUBSIDIARY MODEL

#### **Introduction**

1. On 21 November 2011 Ofgem commenced a consultation with BSC parties, BSC panel members and other interested parties on the potential expansion of the role of ELEXON. The consultation seeks views on two models. Under the first of these National Grid Electricity Transmission plc ("**NGET**") would transfer ownership of BSCCo to a new umbrella holding company ("**ELEXON HoldCo**") which would be the parent of an ELEXON group of companies, each formed to fulfil a special purpose (the "**Subsidiary Model**"). The other model involves the ownership of BSCCo remaining as it is, and any activities which do not remain "in house" being provided through a services contract between BSCCo and a new, commercial for profit, service provider (the "**Contract Model**").
2. In its consultation document Ofgem states, amongst other things, that its key concern in relation to the Subsidiary 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. In relation to this concern Ofgem has sought responses on the following questions:

*"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?"*
3. This paper sets out how an effective ring fence could be implemented under the Subsidiary Model, taking into account existing protections in the BSC and drawing on ring fence provisions which exist in analogous scenarios within the electricity and other sectors.

## Effective ring fence

### 1. Costs and Funding

Objective: to ensure that the costs of carrying out non-BSC activities are not passed through to BSC Parties

Risk	Existing Provisions	Suggested additional provisions	Comment / Precedent
New activities in BSCCo	Section C1.2.2 already prohibits BSCCo from carrying out activities other than those provided for in the BSC.	Extend prohibition to holding non-BSC investments	As funds received from the BSC Parties cannot leave BSCCo such funds will not be applied to non-BSC activities
Transfer of funds from BSCCo to other group companies	<p>As BSCCo is already a not-for-profit company funding from the BSC Parties will not be leaked up the chain to its shareholder in the form of dividends.</p> <p>In addition, Section C 3.4.3(b) prohibits BSCCo from making loans or granting any credit without BSC Panel approval other than in the ordinary course of business.</p>	<p>The BSC could be strengthened to expressly prohibit cross subsidies and other payments or asset transfers between BSCCo and its affiliates.</p> <p>The BSC could be strengthened to include provisions which will ensure, amongst other things, that any intra-group services (e.g. HR services or facilities) are provided on arm's length terms.</p>	<p>There is precedent:</p> <p>Standard Condition B5 of NGET's transmission licence contains a provision that NGET must procure that its transmission business must not give or receive any cross-subsidiary from any of its other businesses or its affiliates. Similarly Standard Condition B9 restricts payments and transfers of (or making available) assets to affiliates, subject to certain exceptions (e.g. payment properly due for any goods, services or assets provided on an arm's length basis and on normal commercial terms).</p>
BSCCo being over charged for use of non-BSC assets	No existing provisions.	The BSC could set out mandatory procedures to ensure that where common or shared costs are incurred in respect of BSC and non-BSC activities the basis upon which the BSC Parties should be charged is a fair and reasonable proportion of these.	The BSC Parties' means of benefiting from the restructuring will be a reduction in overall costs, due to sharing of resources and any associated efficiencies. It will be important therefore to ensure that the converse position does not arise with BSC Parties funding the common costs of the non-BSC businesses.

2. Assets and resources

Objective: to ensure that the assets and resources necessary to provide the BSC services remain available for the provision of such services.

Risk	Existing Provisions	Suggested additional provisions	Comment / Precedent
Disposal by BSCCo of its assets	Section C3.4.3(d) already prohibits BSCCo from disposing of IPR rights or other rights held in any BSC Systems.	None.	This is sufficient for the type of assets which BSCCo owns in order to conduct its activities.
Use of BSCCo assets by other group companies	No existing provisions.	Such assets to be made available on an arm's length basis and on normal commercial terms (unless the consent of the BSC Panel has been obtained).	This is the position under Standard Condition 41.3 of the electricity distribution licence.
BSCCo borrows excessively	Section C3.4.3(a) prohibits BSCCo from entering into borrowings exceeding £10,000,000, without BSC Panel.	-	This already ensures that BSCCo does not become financially distressed
BSCCo resources are transferred to other group companies	No existing provisions.	<p>The BSC could require BSCCo at all times to act in a manner which will secure that it has available sufficient resources, including management, operational and financial resources and other assets, to enable it to properly and efficiently carry out the BSC services and comply with its obligations under the BSC.</p> <p>This could be reinforced by a certificate approved by the BSCCo Board and backed up by an auditor's report.</p>	Such provisions exist in NGET's transmission licence (Standard Condition B7) and the electricity distribution licences (Standard Condition 30).

3. Limiting exposure to non-BSC activities

Objective: to ensure that the BSC business is not exposed to risks unrelated to the BSC services

Risk	Existing Provisions	Suggested additional provisions	Comment / Precedent
Collapse of one company causes the collapse of an affiliate	BSCCo is and will remain a separate legal entity from other group companies.	None.	The corporate structure itself will ensure that (in the absence of express support) the risks of one business are kept separate from another.
Creditors enforce security over the assets i.e. they sell BSCCo assets	Section C3.4.3(c) already prohibits BSCCo from encumbering or creating security over its assets without the approval of the BSC Panel.	BSC Parties' position could be further protected if security is granted over BSCCo's assets in favour of a trustee or other agent for the benefit of the BSC parties.	This will ensure that any security granted in contravention of the restriction will be subject to the existing security for the benefit of the BSC Parties.
Creditors enforce security over the shares of BSCCo i.e. they sell BSCCo	Section C2.2.2(c) prohibits NGET from creating security over its shares in BSCCo.	If ELEXON HoldCo were to replace NGET as BSCCo's shareholder an equivalent provision could be included in the BSC to be binding on ELEXON HoldCo.	The security over the shares would give the trustee or agent a first ranking security interest and prevent them being sold to satisfy creditors' claims.
Breach by an affiliate of its agreement(s) automatically triggers a default by BSCCo of its agreement(s).	No existing provisions.	Include a restriction on BSCCo entering into agreements containing cross-default provisions (i.e. where BSCCo may be placed in default on account of the actions of or circumstances affecting its affiliates).	Such provisions are typically included as licence conditions (e.g. Standard Condition B9 of NGET's transmission licence).

## **Monitoring and Enforcing the Ring Fence**

### 1. Monitoring and Reporting

As noted by Ofgem in its consultation document the role of the BSC Panel extends to the management and implementation of the BSC rules as set out in the BSC. Similarly the non-executive BSC Board plays a role in this process. ELEXON does not consider that material amendments will need to be made to these bodies to enable them to monitor and enforce the ring fence (although there will need to be adequate and appropriate resources for them to carry out this role).

Objective: to ensure that information is available to monitor the BSC rules relating to ring fencing as set out in the BSC.

<b>Risk</b>	<b>Existing Provisions</b>	<b>Suggested additional provisions</b>	<b>Comment / Precedent</b>
Insufficient information to monitor compliance with the ring fence	There are already relevant provisions within Section B (e.g. paragraphs 6.1.1 to 6.1.3 require the BSC Panel to prepare and provide to all BSC Parties and Ofgem an annual report, and paragraph 2.3.4 restricts NGET from consolidating financial results of BSCCo with the transmission business).	<p>BSC could include the following (applying directly to ELEXON HoldCo as well as BSCCo):</p> <ol style="list-style-type: none"> <li>a. the preparation of annual audited accounts of BSCCo in a specified format identifying, amongst other things, items charged to BSCCo by its affiliates or charged by BSCCo to its affiliates;</li> <li>b. an obligation on BSCCo to provide such information and reports as are necessary to monitor compliance with the ring fence;</li> <li>c. the maintaining for a specified period such accounting records and other records as are necessary so that the revenues, costs, assets, liabilities, reserves and provisions of the BSC business can be separately identifiable in the accounting records of BSCCo and of any affiliate from those of any other business of the ELEXON group of companies.</li> </ol>	

## 2. Enforcing the ring fence

In addition to being an industry code the BSC is a contractual document and could be enforced as such.

Objective: to ensure that the ring fence can be enforced.

Suggested additional provisions	Comment / Precedent
<p>Step in rights and a transfer back mechanism could be included in the BSC to enable the BSC Panel, in a scenario where BSCCo was in default of its BSC obligations, to step in to direct and manage performance/compliance by ELEXON either on a temporary basis or as a precursor to transferring BSCCo out of the ELEXON group of companies and back into the control of NGET or BSC Parties.</p> <p>In order to ensure that the step in and transfer mechanism can be enforced against ELEXON HoldCo, ELEXON suggests that ELEXON HoldCo is made party to the BSC for this purpose.</p>	<p>Step-in rights are often given to lenders in project finance transactions to enable the lenders to step in and manage the project where the borrower is not performing its obligations. Similarly step-in rights are often afforded to Public Authorities in PFI projects to enable them to step in to perform the relevant services in certain circumstances.</p>
<p>Appointment of an agent to take enforcement action. This could be NGET or another entity nominated for this purpose in the BSC. Whichever entity is chosen for this purpose would need to be held harmless by the BSC Parties in a similar way to BSCCo now.</p>	<p>As the BSC Panel is not a legal entity the BSC would need to appoint an agent to conduct any legal proceedings to enforce their rights against BSCCo or ELEXON HoldCo. Currently Section C.3.3.1 and C3.3.2 of the BSC provides for the BSC Panel to instruct BSCCo to take proceedings against a party in breach of the BSC on behalf of the other parties, and for the BSC Panel (or BSCCo or a panel committee) to conduct such proceedings. However there would need to be a different entity to enforce the step in and transfer mechanism against BSCCo (or ELEXON HoldCo).</p>
<p>The BSC could include a requirement on BSCCo to maintain an implementation and handover plan, so that a new senior management team will have access to the key financial and operational information necessary to operate the business.</p>	<p>To ensure that the transfer of the BSC business could be effected smoothly and without interruption to the services (and thus ensuring that this ultimate sanction is credible). Key operational management will in any event transfer back with BSCCo.</p> <p>The requirement to put in place an implementation plan is one of the proposed modifications to the Network Operator Licence referred to in Ofgem's March consultation. There are also precedents for the requirement to maintain appropriate handover plans in other sectors (e.g. rail franchise agreements).</p>
<p>The inclusion of the step in and transfer back mechanism described above should give the BSC Parties an adequate means</p>	<p>A claim for contractual damages made on behalf of the BSC Parties against BSCCo would, given the existing cost recovery model, result in the cost of satisfying the claim</p>

<p>of enforcing compliance by BSCCo.</p> <p>The introduction of financial penalties would not be appropriate for BSCCo unless BSCCo also benefitted from having the upside of a profit stream which the current model does not provide.</p>	<p>being passed through to the BSC Parties.</p> <p>However if the BSC Parties feel that a financial incentive to perform is necessary in addition to the step in and transfer back mechanism, one possibility would be to modify the cost recovery model. For example, BSCCo could charge the BSC Parties on a cost plus margin basis and the margin would be available to fund financial penalties.</p>
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3. Ring fence provisions not appropriate for Contract Model

The suggested additional ring fencing provisions described in this paper are relevant only to the Subsidiary Model. ELEXON considers that it would be inappropriate for similar ring fence provisions to be incorporated within the Contract Model because in that model the risks of cross-subsidy do not exist.<sup>1</sup>

4. Licensing BSC activities

ELEXON recognises that it may appear attractive to Ofgem to create a new licensable activity of administering the BSC, as this would give it direct enforcement powers through the relevant licence conditions. ELEXON however does not think that this is necessary, as the protections and remedies set out in this paper should be fully capable of protecting BSC parties. In addition this would require primary legislation and therefore would materially impact on the complexity of and timescales for implementation.

**B. TRANSFER OF OWNERSHIP**

1. As indicated above, ELEXON considers that the new owner of BSCCo in place of NGET (the BSCCo Shareholder) should become a Party to the Code.
2. Section C2.2.3 already enables the Authority to direct NGET to transfer ownership of BSCCo to another entity upon payment of the par value of BSCCo's shares.

**C. VIRES RESTRICTIONS**

1. ELEXON considers that the BSC should, for the avoidance of doubt, clarify that its affiliates (except subsidiaries) are not restricted to BSC activities. ELEXON does not propose any change to the vires restrictions applicable to ELEXON and its subsidiaries in the BSC.

**ELEXON**

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<sup>1</sup> ELEXON understands that Ofgem also shares this view.