Elexon vires meeting

Elexon's offices on 8 December 2011

Rachel Fletcher (RF) introduced the seminar, stating that this was an opportunity for participants to give their initial impressions on the consultation and examine how any agreed model could be implemented. RF was interested in hearing thoughts on the process, particularly around the role of Ofgem and Elexon in that process.

RF recapped on the letter, emphasising that Ofgem was supportive of Elexon's desire to pick up work outside the BSC including getting to a point in principle where it might bid for the Data and Communications Company (DCC) contract. Ofgem could see a case for making use of the knowledge and expertise in Elexon in the overall interests of the consumer. Ofgem had thought very hard about the conditions that would need to be in place to protect BSC parties and customers.

RF outlined the two models; the contract model and the subsidiary model noting that Ofgem currently thought that the contract model would better meet the conditions. Both models would require a lot of thought and effort in terms of implementation; neither would be a quick fix. Whichever model was implemented would require Elexon to seek an equity partner to bid for DCC.

The key issue with the subsidiary was the extent to which one could realistically create adequate ring fencing and ensure that BSC money was only used for the BSC and that resource wasn't dragged into profit earning subsidiaries. The contract model was not without difficulties and the extent to which there was an advantage depended on whether BSC Parties could hold the body to account and be confident it was being paid a fair return for the services Parties received.

Ofgem considered there was a case for a short term contract, i.e. three to five years, before parties went out to competitive tender rather than through negotiation with a single party. RF asked which was easier - striking a reasonable contract (albeit short term) vs. enforceable ring fencing in a subsidiary.

RF invited Elexon to take the floor and give a high level reaction to the consultation. Mark Bygraves (MB) responded on behalf of Elexon. He said Elexon had flagged the vires issue in the present year's business plan pointing out that this was not just about being able to bid for DCC – there were so many things going on and Elexon passionately believed that there was a role to play in the central body landscape to make the most of its assets governance needed to be changed.

Elexon agreed with the four conditions, though some needed to be clarified. On funding he said it had never been part of Elexon's proposition that parties would need to fund the new model; it intends to look for new equity though it is difficult to progress this until their vires is unlocked. Whichever model was adopted there would be challenges and issues. Elexon considered that a three year term would be de-stabilising, and a dislocation for those staff focusing on re-procurement of major contracts 18 months in. A shorter contract increases costs because of the timeframe available to recover them. If the profit element of a contract could be monetised it may avoid the need for equity.

Elexon believed that the costs of implementing the contract model would be higher because of the need for teams to negotiate, monitor and enforce the contract. A contract would also introduce a profit margin, while at the moment Elexon is cost pass-through only. MB analysed Elexon's costs, noting that around £15m was already outsourced (and includes a profit margin for service providers). Taking out the lease and property costs this left around £10m of operational, squeezable costs to outweigh increased contract costs.

MB commented on the 'thick' vs. 'thin' approach; someone would have to oversee the contract and that would require resource. Making BSCCo 'thicker' may result in a duplication of costs between BSCCo and the service company. Turning Elexon into a service company may also create a different set of behaviours; e.g. being restricted to what is provided for in the contract.

MB acknowledged that there were issues with a subsidiary model. Elexon understood RF's point about ring fencing money, assets and people. Elexon did believe that ring fencing could be strengthened and reinforced with the right to step in (and transference back to NG if necessary). Ring fencing already existed in the BSC, i.e. Elexon has audit trails and the assets cannot be sold. He considered that the subsidiary approach is therefore simpler.

MB reiterated that funding was an issue for both models and that Elexon had never said that parties should provide the money.

Everyone should be clear that with a contract model one wouldn't see 'behind the contract', for example whether the service was being provided by one person or 100. All that would be seen was whether the KPIs were fulfilled and service levels met. It wasn't appropriate to take ring fencing and apply it to a contract model. Ofgem and parties had to decide what they wanted.

MB said that when Elexon proposed its new structure earlier this year it recommended a company limited by guarantee whereby profits generated within the group stayed there; they were not distributed out to shareholders but used to lower the overheads of the group or explore new avenues.

A company limited by guarantee was consistent with both models. Consideration needed to be given to whether Elexon could be owned by the many or the few i.e. whoever turned up with an equity cheque.

Paul Mott (PM) said that it was proposed to let the DCC contract for ten years with provisions for re-openers; it would be desirable for a degree of consistency. He asked whether a three year contract meant that DECC would go out to tender again

RF said that the idea of a short term was to protect parties i.e. not just to negotiate with one party who had all the information. There were ways of mitigating some of these concerns – this would imply the thick vs. thin model and another way was a short contract to all BSCCo to benefit from a properly competitive arrangement. The DCC and this BSC contract were completely separate.

David Smith (DS) asked what contract term Elexon would be more comfortable with.

MB said three years was too short, he'd advocate ten given the stability the industry needed and the longer period over which to spread costs; this was similar to the period afforded to others in the industry and would avoid clashes with agent re-procurements and other issues affecting the industry more widely.

Peter Bolitho (PB) agreed that three years was too short; ten years was too long. The focus previously in the Issue 40 group was that the contract should be awarded to Elexon in the first place; it was the threat of losing that contract which would keep Elexon on the ball. Five years was a more appropriate contract term. MB added that a contract would include termination rights; if Elexon got it wrong the ten year contract could be terminated sooner.

PB said the key task in a subsidiary model was ring fencing; this would be really difficult and potentially undermine the benefits which could be achieved. Resources could be shared more efficiently in a contract model. He drew an analogy to ring fencing between distribution and supply; this approach wouldn't be feasible in a small company like Elexon.

Garth Graham (GG) said that in a subsidiary model Ofgem and DECC would have to consider whether, as new elements were added, it becomes 'too big to fail' issue. I.e. they wouldn't allow BSCCo to fail, so NG would have to step in if Elexon went bust.

RF said that to be clear ring fencing had two separate but related purposes; first to give assurance to customers that money spent on network charges didn't end up funding generation etc and secondly to ensure that the assets, skill sets and resource were intact and were the wider group to face distress the assets would be protected. In those areas there were special administration schemes and someone else could come in and run the network service. The issue for Ofgem was enforceability in an unregulated entity – penalising or taking enforcement action against Elexon is not currently practicable.

Collette Baldwin (CB) said that in Issue 40 there'd been talk of the rate card being charged back. CB was concerned that part of a new subsidiary would bid for other work, the resource would have been used and loaned back to BSC but that there may be no revenue if the company failed to secure the bid; this would expose BSC parties.

MB queried whether her preference was to pay more for a contract to protect her from that.

GG said the approach was not new; Elexon did this already with Logica. In a lean model the assets could be left to anyone tendering for DCC so synergy benefits could be made available to BSCCo to others as well as Elexon and they could later factor that in to their bid for DCC.

Nigel Cornwall (NC) welcomed the consultation. He was worried that the industry would now devote a lot of time to criticising models it didn't like. A level of fundamental change was needed; last year's business planning exercise demonstrated how much pointless energy can be expended. He agreed change was needed for a number of reasons including leveraging Elexon's ability to retain its staff. Talk of the DCC muddied the waters; it drove the timetable but not the issue in hand. Legitimate issues need to be considered this was not just about allowing Elexon to be the DCC. RF agreed.

NC had two criticisms about the document; it was good and set out the issues but the three year issue was a red herring and if, for arguments sake, you said this is about allowing Elexon to pitch for the DCC then a three year contract wouldn't do that; it needed to be five years to be bankable. He said personally he thought the three years might be driven by EU processes. RF said it wasn't; it was an example of what was meant by short term though there may be procurement issues with a lengthier period which would need to be bottomed out. Ofgem was not fixed on three years but negotiating a contract with only one party might not give an optimum outcome. How long a contract were people comfortable with? NC said there wasn't a right length; it depended on an orderly business cycle – for example the smart metering programme extended to 2019 and during that period people wanted certainty.

PM said that Ofgem's four conditions could only be met if millions weren't spent before 2012. Costs would arise soon and he asked for an assurance that parties weren't funding this straight away so that if something didn't come along parties weren't stuck with the costs. RF said Ofgem was absolutely clear – BSC parties would not fund this. PM asked if Ofgem would monitor spend. NC reminded him that there were mechanisms in place now to monitor spend and the there was no chance that the Board would agree to it. PM asked if BSC parties were in the majority on the Board, Barbara Vest (BV) said no. NC suggested that the Board would be acting illegally and breaking its fiduciary duties if it did permit unauthorised spend.

Sandra Bain commented on RF's reference to a first time contract; everyone already knew what Elexon's cost were, it was all open book – the information was in its business plan so the risk of negotiating with one party wasn't quite so great. Parties would know if it was trying to pull one over.

RF concluded her session by saying that the workshop was no substitute for a full reply; she and her team were available if anyone wanted time with them. She handed over to Lawrence Irlam (LI) to talk about process.

LI focussed on the key elements of both models, detailed tasks and timelines and next steps. He presented a schematic of the current arrangements i.e. everything was very safe and set out in the BSC which contained obligations for parties and for BSCCo so that was the departing point.

The proposals were to split up responsibilities, set up a new Hold Co and providing services to the conditions and lengths negotiated. The subsidiary model was similar but with new governance arrangements and the BSCCo Board would have new responsibilities, with obligations set out in the BSC. There were similarities between the two models and the process needed to progress them including modifications, issues around due diligence, raising capital to absorb the risk of the new party's start up costs, ring fencing and development of a service contract.

He described the timeframes and tasks outlining what had to be done as a minimum to allow Elexon to bid for DCC including obtaining equity for its bid, a decision on its preferred model - a structure needed to be in place compatible with DECC's timetable - heads of terms for the contract and bid plus ring fencing, resourcing for start up and a sponsor for BSC modifications to unlock the vires. He asked if anything was missing.

Stuart Cotten (SC), Drax, asked what decisions would be made in 2012; there was no model, no modification and no significant code review process. RF responded saying that Ofgem was consulting on conditions as well as providing initial thoughts on models. It recognised the issue 40 group was inconclusive and unless Ofgem said, based on the information available to it, it would be more appropriate to go for model a) or model b) then the industry could talk for a long time. When Ofgem made its decision following consultation this would not be a statutory decision but it would say what principles it would consider when reviewing modifications to deliver the change.

SC said there was always the status quo but that Ofgem seemed to think this wasn't an option. RF said that if the outcome of the consultation were really clear views that neither of these models would work with Ofgem's principles then the status quo was an option but she hoped some of the cons of that were clear. Ofgem was supportive of Elexon's ambition and protecting the BSC was not negotiable. The next step would be to see a modification raised; Ofgem would not look at this in isolation and it would have to be satisfied that the entire package was compatible.

SC asked who Ofgem saw raising the modification; would it be NG as current shareholder? Jon Dixon (JD) said that further work is ongoing during the consultation period. Ofgem hope that a modification will be ready by the time it makes a decision on the way forward, allowing the proposal to hit the ground running. Some changes could be fast-tracked and there was nothing to preclude others to raise modifications.

Richard Hall said that at the moment the principles were all about things not getting worse; DECC was clear that it didn't want DCC to be funded by the industry. Where was the upside for parties to raise a modification? JD said that changes should allow efficiencies for BSC parties – Ofgem's conditions wouldn't be met if these didn't materialise. MB said that Elexon had identified under the subsidiary model if Elexon could secure the DCC tender approx £1m would be available to be returned to parties. Both NC and BV pointed out that previous references had said this would be reinvested in the business – which was it?

NC said that there was a risk Ofgem would only hear negativity; it was hard to quantify tangible benefits and how something might better the applicable objectives. He also referred to implementation and looking at fast tracking changes to allow participation in the DCC; the industry was not good at fast tracking - it could take six or seven months to make an obvious change. He said there'd be no shortage of modifications but the timeframes didn't help. A group should be established which, without having an editorial view, looked at issues and recommended to the Panel what they were and what timescales were. RF said this was a good point. Ofgem was very aware of timing which was why it was being more directive. It had some thoughts on the implementation process and was keen to get comments on process. The issues were not just about detail; it was vital to get everyone comfortable with the agreed position.

PB said lots of work had been done and, of those who supported change, the balance of view was in favour of the contract model; if all parties coalesced around that then that was one way of expediting the process. RF said Ofgem was running the consultation for a purpose; its mind was not made up.

LI said a series of working groups would be set up. In response to questions he clarified that these would be Ofgem rather than BSC working groups; with initial papers provided as part of Elexon's response to the Ofgem consultation. MB agreed that Elexon could provide a draft paper on ring fencing and 'step in' provisions for both models. The assets, the building and the contracts would be affected by changes in control and the question of where they best sat and the impact on pensions was common to both models. Elexon would also come up with heads of terms for contracts. It was emphasised that this wasn't a fait accompli; but about taking the opportunity to do some work that could have been done earlier and provide something for BSC parties to consider.

GG asked if the proposals would be 'thick' or 'thin'. MB said that was up to parties; it was not part of the contract. However, the assumption is that everything is outsourced, so it would be a thin model. GG asked if a thick model could be worked up too.

MB said that building on the Issue 40 group the discussions around thick and thin models were around how much resource was needed to monitor a contract and to decide how much resource stayed in BSCCo.

NC said that this was an analytical not an advocacy exercise, so whether discussion was in the Issue 40 group or elsewhere detailed understanding of the mechanisms is needed. He warned against losing sight of the fact that there wasn't much difference between the two other than the governance issue and people shouldn't get too emotional about that.

JD said that more information would be in Elexon's submission. Ofgem's decision would be out by the end of January/beginning of February and hopefully it would opine and set out a work plan. Ofgem wasn't ruling anything out and it didn't want to choose models purely for the sake of expediency.

Lisa Waters (LW) asked if Elexon could look at other things; she was confused as to why it wanted to do DCC. Her clients weren't interested in Smart and were worried about liabilities. LW was concerned that there are further things on the horizon, such as EMR and Ofgem's retail review, which combined will make it difficult for Elexon to cope.

NC said that the Smart Energy Code was a more tangible and practical thing that Elexon might do.

LI asked if the Issue 40 group was a suitable body to progress with and to establish sub groups. LW said that he was talking about a lot of groups when the industry was up to its eyes in RIIO, the retail market review and Electricity Market Reform (EMR). JD clarified the position – Ofgem wasn't necessarily talking about groups what it wanted was a body with a different perspective to provide a sense check. GG asked when this would be done. LI said Ofgem was looking to move early so whenever the industry could mobilise itself. LW said the Authority was setting a very optimistic timetable.

NC said the Panel didn't meet until the second week in January; there were lots of committees but the people who had a view would want to participate. JD said 2011 could be ruled out. Ofgem had everyone's contact details; it would seek to disaggregate the work manageable chunks and provide a timetable for comments. Attendees could then put their names against areas of interest/expertise. NC suggested the Andrew Pinder (BSC Panel Chair) should also be asked to ask the Panel whether the Issue 40 group could be reconvened and ask the Elexon management to synchronise thinking and get the group to meet.

SC said that Elexon needed to be in the Issue 40 group with Ofgem leading and chairing – the group needed to be independent; going back to the Panel would slow the process down. JD agreed on the basis that there was no BSC issue yet to be resolved and that an Ofgem group should be set up. Nigel said he had no problem with that – we just needed to get traction quickly. GG sought clarification that no groups would meet before

Christmas. JD agreed it would be premature; Ofgem wanted responses and the body of work Elexon prepared to inform the groups' debate from 6 January onwards.

Attendees:

Nigel Cornwall (NC)	Cornwall Energy
Barbara Vest (BV)	AEP
Peter Bolitho (PB)	E.ON
David Lane	Clear Energy
Dick Brealey	Independent Panel Member
Kevin Woollard	BG
Collette Baldwin (CB)	E.ON
Garth Graham (GG)	SSE
Mo Rezvani	SSE
Paul Mott (PM)	EdF
Varsha Patel	EdF
David Smith (DS)	Npower
Cem Suleyman	Drax
Stuart Cotton (SC)	Drax
Chris Greer	Green Energy
Howard Wright	APX endex
Catherine Bakhshi	DECC
Ken McRae	Gemserv
Brian O'Shea	Electralink
Phil Hewitt	Enappsys Ltd
Paul Verrill	Enappsys Ltd
David Hawkins	Parsons Brinckerhoff
Sue Wallbank	PwC
Sandra Bain	Logica
Suneel Kumar	Cognizant
Christine Pearson	Engage Consulting
Lisa Waters (LW)	Waters Wye
S Wolfe	Consultant
Adrian Clough	Herbert Smith
Peter Haigh	Elexon
David Osborne	Elexon
Victoria Moxham	Elexon
David Ahmad	Elexon
Mark Bygraves (MB)	Elexon
Dorcas Batstone	Elexon
Rachel Fletcher (RF)	Ofgem
Jon Dixon (JD)	Ofgem
Lawrence Irlam (LI)	Ofgem