Elexon Limited, BSC Parties and
other interested parties

Promoting choice and value for
all gas and electricity customers

Direct Dial: 020 7901 7355
Email: industrycodes@ofgem.gov.uk

Date: 30 April 2012

Dear Colleagues,

Potential expansion of role of Elexon

In November 2011 we consulted[1] upon a potential expansion of Elexon Limited's ('Elexon') scope and vires to allow it to take on additional work beyond that set out in the Balancing and Settlement Code ('BSC'). This was driven primarily by Elexon's desire to participate in the Government's anticipated competition to operate the Data and Communications Company ('DCC'). However the potential changes to the BSC could enable Elexon to take on other roles.

Elexon administers the BSC for Great Britain. Elexon's role in operating the settlement mechanism on the industry's behalf is critical to the effective operation of the electricity market. Elexon has built up extensive experience of settlement and the procurement and management of contracts to fulfil its current expert role. However, Elexon's current constitution and certain provisions within the BSC may prevent it from diversifying. Elexon considers that Ofgem's involvement is necessary in order to facilitate the removal of these impediments.

Our consultation set out several conditions which we considered should be satisfied before Elexon expands its scope, with the aim of protecting the BSC Parties and ultimately consumers. The consultation also identified two possible restructuring models for Elexon that could satisfy our conditions. The preliminary view we released for comment was that while either of the two models would be viable, the 'contract model' would most effectively meet our pre-requisite conditions.

Having considered responses to the November 2011 consultation[2], we remain of the view that any proposed expansion by Elexon would need to meet some key principles as reflected in our pre-requisite conditions, which we have modified in light of comments. We also remain of the view that a contract model appears most likely to effectively mitigate the size and nature of risks associated with Elexon undertaking an activity such as the DCC. In particular, we are concerned that the alternative 'subsidiary model' may not contain appropriate protection for BSC Parties against implicitly underwriting the risks faced by Elexon in undertaking non-BSC activities.

However, we acknowledge the concerns raised by several consultation respondents, including Elexon, that a contract model may be more expensive to implement and subsequently administer, while also potentially making it more difficult for BSC Parties to extract value or other benefits from a future expansion of Elexon's activities. We therefore

[1] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=216&refer=Licensing/IndCodes/Governance
[2] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=216&refer=Licensing/IndCodes/Governance

consider that there may be more proportionate means of allowing a limited expansion of Elexon's activities without requiring its separation from the BSC Company (BSCCo) in the form of the BSC Board.

We also note some stakeholder comments around the governance of the BSC Board and its relationship with both the BSC Panel and Elexon management.

Ultimately the method of any restructure and further changes to the BSC governance arrangements will be up to Elexon and other stakeholders to consider and propose through the BSC modification process.

Background

Given Elexon's aspirations to diversify, we commissioned an independent advisor to help us understand the issues that may arise and how these may be addressed. Their report was subsequently published on 29 July 2011[3]. In parallel, a BSC Issues Group was convened to look at the impacts upon BSC governance. The group published its findings on 7 September 2011[4]. Both reports contained similar suggestions for the possible reorganisation of Elexon and formed the basis of Ofgem's November 2011 consultation. In that consultation we focussed on two possible models.

The first model would require the creation of a new, Elexon-branded holding company, to which the BSCCo would become a subsidiary. Sibling companies would then be created within the new group to undertake new activities, such as operating the DCC. Relationships and resource flows between these subsidiaries would be governed primarily by the holding company, subject to any ring-fencing arrangements. This model is referred to in our consultation and in this letter as the 'subsidiary model'.

The second model would retain the existing regulatory framework, but enable BSCCo to outsource some or all of the work currently carried out in-house to a newly formed and legally separate entity ('New Elexon') under the terms of a negotiated contract. Under this 'contract model', New Elexon would be able to operate as a normal commercial organisation, free to compete for additional work beyond its initial BSC services contract.

Ofgem's November 2011 consultation document highlighted the potential for cost savings and other synergies arising from Elexon expanding its current role under the BSC into other functions, such as the DCC. We were therefore supportive in principle of Elexon's desire to diversify, provided that this would not be to the detriment of the BSC arrangements or at the expense of BSC Parties. We set out pre-requisite conditions for any expansion; these are discussed further below.

On 8 December 2011 we held a stakeholder workshop which gave interested parties an opportunity to express their preliminary views on Ofgem's consultation. The slides presented at that workshop and a note of discussions are available on Ofgem's website[5], alongside some further papers completed by Elexon as a result of that workshop (these papers set out specific aspects of each model in more detail).

In the annex we provide a summary of respondents' views to all of the questions asked in our November 2011 consultation letter. Non-confidential responses are available in full on our website[6].

[3] See: www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Elexon%20report%20final.pdf
[4] See: www.elexon.co.uk/ELEXON%20Documents/Issue_40_Final_Report.pdf
[5] See: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=235&refer=Licensing/IndCodes/Governance
[6] See: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=216&refer=Licensing/IndCodes/Governance

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Conclusions

Having considered responses to our consultation we remain of the view that there may be benefits in facilitating the removal of structural obstacles to Elexon's diversification. We also confirm that any diversification must meet our pre-requisite conditions, as follows:

1. BSC Parties should benefit from any diversification;
2. The arrangements should not place disproportionate risk on BSC Parties;
3. Standards of service under the BSC should be maintained; and
4. Elexon's BSC role should not give it any undue competitive advantage in a contestable activity.

Our rationale for making changes to these conditions is set out in the Annex to this letter, where we also set out some further thoughts on the questions raised in our consultation.

To the extent that any new activity would entail a materially higher level of risk, we remain of the view that a formal separation between the BSCCo and a 'New Elexon' is better able to protect the interests of BSC Parties. However, recognising the significant implementation and ongoing operational costs of such a contract, we also consider that an alternative model may offer sufficient safeguards if the level and nature of risk that Elexon - and by association BSC Parties - take on is limited; this is explored further in the Annex to this letter. In other words, any re-organisation should be proportionate to the scale of risk it is intended to safeguard against. These are matters for Elexon and stakeholders to consider as part of any proposal to modify the BSC that would facilitate an expansion of its role.

Next steps

While the opportunities for Elexon to diversify are by no means limited to the forthcoming DCC competition, or indeed necessarily to work within the electricity sector, the timing of Elexon's restructuring may still be, to an extent, dictated by the DCC timetable. We would expect this to be reflected in the associated timetable for progressing any necessary BSC modification proposals.

For the avoidance of doubt, this letter does not prejudge the outcome of any modification proposal. Ultimately, Ofgem's role in this process will be to ensure that any modification proposals are in line with the BSC applicable objectives, as well as taking into account our pre-requisite conditions and wider statutory duties.

If you have any questions in relation to this letter please contact Lawrence Irlam on 020 7901 3064 or at lawrence.irlam@ofgem.gov.uk.

Yours sincerely,

Hannah Nixon
Senior Partner, Smarter Grids and Governance - Distribution

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Annex – Summary of responses and Ofgem's further views

This section summarises the key points from responses to our November 2011 consultation document.

We have also received several comments in relation to the supplementary documents[7] provided by Elexon following the December stakeholder workshop. Those supplementary documents are not dealt with in this letter, though we will have regard to any comments received to date and in the coming months, as part of our further work in facilitating these governance changes.

Our pre-requisite conditions

In November we set out the conditions that we considered must be met in order for us to accept any expansion of Elexon's role. They were as follows:

1. BSC Parties should not face higher costs;
2. The arrangements should not place more risk on BSC Parties;
3. Standards of service under the BSC should be maintained; and,
4. Elexon's BSC role should not give it any undue advantage in the DCC competition.

We note that the majority of respondents, including the BSCCo Board and Elexon itself, broadly agreed with our conditions, though views differed on the extent to which either of the two models would satisfy those conditions, or indeed whether the diversification should be allowed at all.

Some parties expressed concern that enforcing condition 4 may restrict Elexon's attempts to benefit from any synergies with its BSC activities, and therefore negate the potential for reducing costs to BSC Parties and ultimately consumers. That is not the intention of our condition 4. We recognise that there may be synergies which Elexon can exploit in broadening its role to include the DCC or other opportunities. This should be of benefit to consumers not only through a potential reduction in the currently fixed costs of operating the BSC, but also through adding to the strength of the competition to become the DCC. We do not consider that this would be an undue advantage.

However, we are concerned that Elexon does not currently operate on a truly commercial basis and to the extent its revenues are guaranteed under the terms of the BSC, could have an unfair advantage if it was, for instance, in a position to effectively subsidise any new activities through an inappropriate allocation of costs to its BSC activities. As stated in our consultation letter, we consider that condition 4 would be met provided that BSC parties were not carrying all of the cost and risk associated with Elexon's expansion (conditions 1 and 2). However, we do agree with those respondents who pointed out that condition 4 should not specifically refer to the DCC bidding process, but more generally to any contestable non-BSC activities.

We also consider it important to clarify that we expect there to be implementation costs associated with an expansion of Elexon's role, whichever governance structure is adopted. This condition therefore seeks to ensure that BSC Parties do not face any long run costs, i.e. they should see commensurate and ongoing cost savings within a reasonable period – though not necessarily the year the costs are incurred.

In light of the support and comments from respondents we conclude that we have set broadly appropriate conditions for any expansion by Elexon and will include these conditions in our future evaluations of industry proposals. We will therefore seek to ensure that any additional activity undertaken by Elexon will be subject to the consent of the

[7] The 3 supplementary documents covered: possible contract heads of terms; details on how ring-fencing arrangement could operate within the BSC; and, suggested text for a BSC modification proposal to create a new category of BSC Agent. These are available on the Ofgem website at: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=235&refer=Licensing/IndCodes/Governance

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Authority and that the non-BSC activities must individually and collectively meet our pre-requisite conditions (amended following consultation) as follows:

5. BSC Parties should benefit from any diversification;
6. The arrangements should not place disproportionate risk on BSC Parties;
7. Standards of service under the BSC should be maintained; and
8. Elexon's BSC role should not give it any undue competitive advantage in a contestable activity.

Preferred model

A majority of those respondents in favour of allowing the diversification considered that the contract model would provide the more robust safeguard of the BSC arrangements and best satisfy our conditions. In particular, the contract model would establish a clear separation of interests and responsibilities between a remodelled BSCCo Board and Elexon, ensuring that the BSCCo Board remains principally concerned with the BSC arrangements and that it has appropriate control over Elexon to ensure all requirements are fulfilled to an appropriate standard. A chief concern with the subsidiary model is that resources could be diverted away from the BSC into other activities, particularly if those other activities offered more attractive rewards or punitive consequences for failure.

This confirms our conclusion that of the proposals that have thus far been put forward, the contract model would be the more appropriate model for a long term and substantive expansion of Elexon's role, particularly if the BSC were to provide an ever diminishing part of its business. We also expect that the implementation of a contract model would be relatively straightforward, in essence requiring some or all of Elexon's activities to be prescribed as a BSC Service and Elexon to undertake those activities as a BSC Agent, working within the same framework for monitoring, compliance and re-appointment as existing BSC agents.

We set out some further thoughts in the annex on how the contract model could develop, particularly in light of the issues arising from our consultation. It should be noted that any decision on whether to enter into such a contract would be for the BSCCo Board; therefore any modification to the BSC should appropriately enable, but not require, the outsourcing of some or all of those activities currently undertaken in-house by Elexon.

Limited expansion

We recognise the concerns raised by some respondents that a fundamental restructuring of the BSC arrangements, as would be required under either the contract or the subsidiary model, may not be the most efficient means of allowing Elexon to widen its activities and may prove to be disproportionate. We consider that our conditions could be met without such a reorganisation if the scale, scope and associated risk of any new activities to be undertaken were of a more limited nature than those of a DCC bid, in essence ensuring the primacy of BSC activities to Elexon's management.

Whilst we have consistently been of the view that any new governance arrangements must be future-proofed and facilitate any new activities Elexon may reasonably wish to compete for, it may be appropriate to give further thought to this being part of a long term evolution of the arrangements rather than an immediate step change. Given that there does appear to be widespread support for an expansion of Elexon's role and that the success of a bid for the DCC is by no means assured, it would be appropriate to consider alternative means of unlocking Elexon's vires and potentially securing some, if not all, of the associated benefits.

We consider that an alternative mechanism for facilitating limited expansion of Elexon's vires would be to remove the BSC prohibition on it carrying out non-BSC activities, instead making the diversification subject to the consent of the BSC Board and the Authority. This could be subject to a materiality threshold, for instance being limited to no more than a

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

small percentage of turnover. This would be similar to the restricted activity provisions under Standard Condition B6 of National Grid's Electricity Transmission licence[8].

It is likely that these activities would be governed through a contract between Elexon/BSCCo and the relevant third party who is commissioning them; they would not be set out in or otherwise governed by the BSC. However, it may be appropriate for the scope, as well as scale, of these activities to be restricted, for instance being limited to the utilities sector, or within Elexon's core competencies. Given Elexon's unique position in the electricity market we also consider that non-core services must be offered to any party on a non-exclusive basis.

For the avoidance of doubt, while the BSCCo and Elexon remain synonymous, any new non-BSC activity will require our consent (which will be subject to our pre-requisite conditions being met). In the event of a formal separation between the BSCCo and a New Elexon (as envisaged under the contract model), the pre-requisite conditions must first be met in order for that separation to proceed, but thereafter we would have no purview over New Elexon.

BSC Governance

There was a common theme amongst responses on the need to revisit the governance of the BSCCo Board and its relationship with the BSC Panel. It was noted that the challenges facing the electricity industry, and therefore the BSCCo Board, are different to those envisaged a decade or more ago when the current arrangements were developed. Some respondents felt that the Board needed to be strengthened and given a greater degree of autonomy; others raised concerns with existing working practices and the lack of transparency. We agree that irrespective of any restructure it is timely to look at the governance of the BSCCo. A robust and appropriately constituted Board that operates in keeping with corporate best practice as well as with regard to the BSC applicable objectives will be vital to safeguarding the interests of BSC Parties, both in meeting near term challenges and adding value to the BSC in the long term.

We note that modification proposal P281 has already been put forward by E.on is this respect, and that a workgroup alternative has also been developed. We look forward to seeing the report on these modification proposals.

Contract vs. subsidiary model

The majority of respondents support the contract model in conjunction with Ofgem's conditions. In particular, they felt that contract provisions were more easily enforced than ring-fencing arrangements and therefore more effective in terms of protecting BSC parties' interests. Some respondents also highlighted that a contracting model was successfully employed elsewhere in the energy industry (e.g. MRASCo/Gemserv).

However, several respondents highlighted that the contract model may involve considerable establishment costs which may not be recoverable in the event Elexon fails in its bid for the DCC. Some respondents also considered the subsidiary model might be preferred on the basis that it provides flexibility for Elexon/BSCCo to cope with potential uncertainties arising from broader energy market reforms.

As set out in our letter, we remain of the view that under certain circumstances the contract model would best meet our pre-requisite conditions. In particular, we consider that the subsidiary model does not provide adequate protection for BSC Parties with respect to potential shifting of costs and risks between BSCCo and other Elexon subsidiaries because the ring-fencing elements of this model are not clearly enforceable. By contrast, the

[8] See: http://epr.ofgem.gov.uk/Pages/EPRInformation.aspx?doc=http%3a%2f%2fepr.ofgem.gov.uk%2fEPRFiles%2fElectricity+Transmission+Full+set+of+standard+licence+conditions+consolidated+as+at+05.03.2012+-+Current+Version.pdf

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

contract model would place clear and enforceable obligations on Elexon and BSCCo.

Role of National Grid Electricity Transmission ('NGET')

Respondents considered the role of NGET may not be affected under the contract model, but NGET's relationship with Elexon would need to be reconsidered (if not removed) under the subsidiary model, including NGET's licence as a potential enforcement route for Ofgem.

We do not consider that it is necessary to change NGET's current role in relation to the BSC under the contract model, in particular its ownership of the BSCCo. However, the future ownership of a New Elexon company is less certain. Whilst we would not seek to prescribe the precise nature of any future ownership structure of New Elexon, its management and/or Board should retain an appropriate degree of independence.

'Step in' rights and risk mitigation

Respondents considered that, under a contract model, BSCCo should retain assets and step-in rights in order to mitigate the risk of any financial failure of New Elexon. These features would also maintain pressure on New Elexon to maintain/ improve service delivery. Under the subsidiary model, respondents considered various options to mitigate these risks, including enhancing existing reporting and funding obligations in the BSC and potentially creating a new code administration licence to allow Ofgem to take a greater enforcement role.

Our view is that the BSCCo should retain key assets including BSC Agent contracts and the current premises lease. We also consider that the contract should reflect appropriate "step-in" provisions and/or termination rights to ensure continuity of service.

Length of contract duration

Our November consultation suggested that, given the initial service contract would not be subject to competitive tender and agreed under changing circumstances, this contract should be of a relatively short duration; we suggested that 3 years might be acceptable. There was a common view amongst respondents that this was too short as it would increase uncertainty and costs as well as making Elexon an unattractive investment prospect. Several respondents suggested that the contract should be for a minimum of 5 years, though there were also arguments for up to 8 years in order to take it beyond the expected smart metering roll-out.

We recognise that there is a balance to be struck between the certainty that a longer term contract offers and ensuring that it continues to offer value for money to the BSCCo and BSC Parties. As has been noted by several respondents, a restructuring along the lines set out in the consultation would create significant legal costs as both the Elexon management and the BSCCo Board seek to ensure that the contract is in their interests. A longer term contract will allow a longer period for these costs to be recovered/ offset by efficiencies. We therefore agree with respondents that the initial contract duration should be within 5 to 8 years, though it is appropriate for the final decision to be left to the BSCCo Board as part of contract development.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**