The future arrangements for the Gas Transporter Central Agent

Annex A: Comparator review

February 2013

Final report

CONTENTS

IMPORTANT NOTICE

1. INTRODUCTION

1.1. Purpose

In January 2012 Ofgem issued a decision letter[1] where it concluded that a 'cooperative' model represents the optimal set of future funding and governance arrangements to support the range of centralised data services currently provided by the Gas Transporter (GT) Central Agent, which supports the operation of the Great Britain (GB) gas industry. A consortium led by CEPA[2] has been commissioned by Ofgem to develop options and recommendations for these future arrangements.

This annex seeks to understand how other central service providers to the utilities industry have been set up and what lessons can be taken from these examples in developing appropriate models in funding and governance for the future delivery of central data and information services in the gas industry. The paper is intended to support our main report and the supporting annexes associated with our specific proposals on funding and governance options.

1.2. Process

An initial draft of this paper was submitted to an industry working group.[3] We have subsequently updated the analysis and reflected this in this draft final report. This includes the addition of a review of the funding and governance arrangements of an additional comparator organisation, Electralink, that amongst other functions, delivers a data transfer service that underpins the competitive GB domestic electricity supply market.

1.3. Choice of comparators

Our choice of comparators is based upon how closely the services provided by a central service provider align with the services Xoserve provide and also how this fits in with the development of a cooperative model. Xoserve is as a central service provider established to facilitate delivery of GT licence and Code obligations, focussed on data, information and IT service delivery, so our selection of comparators includes those central service providers that are principally concerned with IT systems and information provision. Our comparator choices would also fit within the ambit of a cooperative model.

Following on from the selection criteria, the main comparators we have considered are:

- Elexon (the Balancing and Settlement Code Company (BSCCo))[4];

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[1] Ofgem (16 January 2012) Open letter: Xoserve Review – Ofgem's conclusions. Available at: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=345&refer=Networks/GasDistr/RIIO-GD1/ConRes

[2] The consortium includes CEPA, ESP Consulting and TPA Solutions.

[3] The industry working group comprised representatives from Shippers, Gas Distribution Network operators (GDNs), National Grid Gas Transmission, Ofgem and the CEPA led consortium.

[4] It is important to note that we have focussed upon the existing arrangements for the BSCCo rather than the BSCCo after proposed modifications, such as the move to the contracting model.

- Meter Registration Agreement Service Company (MRASCo);
- Central Market Agency (CMA), Scotland; and
- Electralink.

We recognise that there are a range of other comparators available, even within the UK gas and electricity industry, but we have chosen not to focus on central service providers that deal with code governance and are not principally concerned with IT and data service delivery. The four main comparators used do not correlate perfectly with Xoserve as, for example, MRASCo and CMA are operationally much less complex than Xoserve and have significantly smaller budgets, while Elexon has a different scope of activities to Xoserve.

Whilst not a direct central service provider comparator with Xoserve, we have also reviewed the funding and governance arrangements of Network Rail, a Company Limited by Guarantee (CLG), to illustrate how this model differs from other company types, such as a Company Limited by Shares. This is intended to show how a CLG structure operates and increase understanding ahead of a decision on company structure, rather than being based on such a decision.

1.4. Document structure

This paper is broken down into the following sections:

- analysis of the comparator industry central agents within the utilities sector listed above (Section 2);
- a review of the CLG structure, examples of this approach and how this model differs from other company types, such as a Company Limited by Shares (Section 3);
- implications of our findings from the comparator models and a discussion of what this means for the choice of our building block elements (Section 4);
- conclusions that will feed into our model choices, given the criticality of the central service provider and the risks of selecting untested options (Section 5); and
- an appendix containing more detailed notes on our comparator examples.

2. CENTRAL AGENTS AND SERVICE PROVIDERS IN THE UTILITIES SECTOR

2.1. Comparators

The table overleaf shows some of the key features of the three key comparator models in the utilities sector which we considered in our original working paper presented to the industry working group. The detail on the funding and governance arrangements for each of these companies is then provided in Appendix 1.

Table 1: Key features of comparator models compared to Xoserve

Element	**Xoserve – GT Agent**	**BSC Co – Elexon**	**MRASCo**	**Central Market Agency (CMA), Scotland**
Service provision				
Scope of activities provided	Data, information and IT systems and services	Payment settlements, BSC administration, IT systems and services	Administration of MRA, data and information transfer services	Develops, operates and maintains central systems; information services and supports the Market Code
How are activities provided?	Partly performed in-house by Xoserve as central agent and partly outsourced to third-party providers	Provides certain services in-house by Elexon, but also procure and manage service contracts with third parties	Outsourced to Gemserv to manage the Agreement, maintain the MRASCo products and operate MRASCo services	Fully outsourced to service provider (principally Gemserv but also a systems integrator/developer - Bridgeall)
Corporate governance				
Company type	Company Limited by Shares	Company Limited by Shares	Company Limited by Shares	CLG
Ownership	Gas Transporters	NGET, but provisions mean full separation of control from ownership	Split between MRA parties with each party receiving one share	Members (Scottish Water and Licensed Providers)
Performance risk (associated with IT systems delivery)	Gas Transporters	Joint liability between BSC parties	Joint liability between MRA parties	Gemserv and systems integrator/developer
Market risk	Mainly GTs, some service users	BSC Parties	MRA Parties	Members

Element	Xoserve – GT Agent	BSC Co – Elexon	MRASCo	Central Market Agency (CMA), Scotland
Profit/ Not-for-profit	Profit	Not for profit	Not for profit	Not for profit
Board composition	Determined by GTs	Independent chairman appointed by GEMA, 2 BSC Panel members elected by Panel, 2 Directors nominated by Chairman	Exec Committee contains 1 member from the Distribution Businesses, 2 members from suppliers and one from the BSC Agent (Elexon)	Chairman, CEO, Scottish Water representative all appointed by Water Commission and two Licensed Provider representatives
Funding and charging				
Cost recovery	Costs can be recovered through price control mechanism, additional costs incurred through Non-Code User Pays recovered directly.	Costs recovered through monthly charges issued to all BSC parties. Contracts with service provider determine cost recovery for capital expenditure.	Issues a direct charge on a quarterly basis to all users of the service to recover what are defined as 'reasonably' incurred costs, based on an annual budget.	A monthly charge is issued to Scottish Water and Licensed Providers. This is based on the annual budget, can be adjusted in the case that the costs incurred in the month differ to those expected.
Charging methodology	Costs allocated through Use of System charging methodology and User Pays arrangements – specified in Agency Charging Statement.	Charging methodology published annually. Around 55% of costs are recovered based on a funding share calculation. The remaining costs are recovered through a series of fixed charges.	Total costs are aggregated and is split between suppliers and distributors, based on proportion of registered meter points (if less than 750,000).Remaining costs split evenly between the businesses with over 750,000 Registered Metering Points.	One-third of costs are allocated to Scottish Water, while the Licensed Providers face the remaining two-thirds of costs split by Meter Wholesale charges (i.e. Degree of use).
Cost overrun	Costs based on actual costs already.	Costs are allocated based on funding shares.	Costs are allocated based on funding shares.	Costs are allocated based on funding shares.

Source: CEPA, TPA and ESP

2.2. Additional comparator

Since our working group paper we have reviewed an additional comparator, ElectraLink. The company operates data and support services across the gas and electricity sectors. Their scope of activities differs from the three comparators in the table above, but we felt the inclusion of this comparator would be beneficial in illustrating a broader context.

Their core service (and the reason for ElectraLink's formation) is providing a Data Transfer Service (DTS) for electricity distribution companies to facilitate the efficient operation of electricity supply markets, as detailed in the Data Transfer Service Agreement (DTSA). The company also provide other data services based on this transfer service and were selected by DECC to be the provider of the data transfer service for the Green Deal.

ElectraLink works across both the gas and electricity sectors, providing essential support services; in gas with the Supply Point Administration Agreement (SPAA) and in electricity with the Distribution Connection and Use of System Agreement (DCUSA), the Distribution Charging Methodology Forum (DCMF) and the aforementioned DTSA.

The company is owned by the 14 electricity distribution licence holders and is a company limited by shares. These shareholders bear the performance risk from the company, but the company Directors can choose to distribute dividends to these shareholders if this is appropriate, although there is ring-fencing around DTS and other commercial services. The company's Board is comprised of a Chairman and five Directors. There is also a User Group, which acts as a forum to put across the views of customer parties.

The funding model is structured using a mixture of User and Supplier charges which seek to identify costs with the users of those services.

In terms of protecting the company against financial risk, shareholder approval is required for services with a value above a certain threshold. The Articles of Association set out that the DNOs will provide up to £3.5m of funding if so required to support the DTS.

2.3. Summary

In this section we have set out the features of our four comparator models. None of these comparators perfectly aligns with Xoserve, so it is important to understand why decisions were made and as far as possible to see how choices around a company's corporate governance, ownership and funding impacts upon their performance. In section 4 we draw out some of the implications from this comparator review and discuss issues which have contributed to our analysis of options for Xoserve.

3. CLGs

In this section we briefly review the institutional framework of a CLG and a key example of where this institutional framework has been applied in GB.

The sections which follow:

- review the key concepts of a CLG as set out in public guidance documents, such as BIS and Companies House guidance on incorporation; and
- the specific governance arrangements in place for Network Rail, the rail infrastructure provider in GB, which is established as CLG.

3.1. CLG Definition

A CLG does not have share capital and its members are guarantors rather than shareholders. The member's liability is limited to the amount they agree to contribute to the company's assets if it is wound up (for example, the amount guaranteed can be as little as £1).

A CLG has a legal identity, the ability to own property in the company's name and the ability to enter into contracts (e.g. service delivery agreements). However, in a CLG, finance comes from the members, from loans or from profits retained in the business as working capital and not from share capital.

Profits of the company cannot be distributed to the members through dividends and that they do not have any claim upon the assets of the company. A CLG is therefore, a form of mutual entity and differs from companies limited by shares in some important respects.

Instead of shareholders there are 'members' appointed to perform broadly the role of shareholders, namely they hire and fire the Board, approve or reject major financial transactions and approve or reject proposed remuneration arrangements for the senior management team in overseeing the management of the company.

In that sense they perform the role of owners, however they have no equity at risk. For example, the members of the company may appoint Directors, often called 'Trustees', who are given the responsibility for creating and implementing policies for the company.

The constitution of a CLG is the Memorandum & Articles of Association. The Memorandum sets out the objects of the company and the powers of the company may be exercised to meet these objects. The Articles of Association for a CLG set out governance processes, such as when meetings of the company will be held and the proceedings of those meetings. They also state the voting rights of members, number of trustees and the powers of the trustees.[5] The Articles also include the procedures for appointing and retirement of members and trustees.

[5] For example, a draft of the Memorandum & Articles of Association of the CMA in Scotland can be found: http://www.watercommission.co.uk/UserFiles/Documents/history/070713%20CMA%20Establishment%20Plan.pdf

Figure 3.1 below sets out a simplified typology of a CLG as compared to the corporate vehicle structure of Companies limited by Share Capital.

Figure 3.1: Simplified Typology of corporate vehicles

Companies limited by Share Capital (usually for-profit) [6]	Private sector majority shareholding, or Public sector majority shareholding, or Mixed share company (private, public, employees, local communities none of which hold a controlling shareholding).
Companies limited by Guarantee (not-for-profit-distribution)	Controlled by Members (representative of wide range of stakeholders – customers, public, employees, business etc). Finance comes from the members, from loans or from profits retained in the business as working capital.

3.2. Network Rail

Network Rail was set up as a CLG following nationalisation after the administration of its privatised predecessor. Whilst being a nationalised company means that Network Rail is different to Xoserve, the example brings out some of the features of a CLG.

Network Rail is a regulated company whose revenue is controlled by the Office of Rail Regulation (ORR). The Network Rail model coped with member numbers as large as 130, who included customer groups, government representatives and other affected parties. The members elect (and can also remove) the Board.

Any financing risk would sit with the creditors if the government did not guarantee 100% of Network Rail's debt through a financial indemnity mechanism (FIM), in exchange for Network Rail paying them a guarantee fee. The liability therefore falls on the taxpayer. Where services have been contracted out to third parties, the risk also transfers to this party.

As a CLG, Network Rail is fully debt financed. Despite having no equity, there is a Management Incentive Plans (MIP) to incentivise the achievement of both annual and long-term objectives. This utilises key performance indicators and levels of cost relative to targets. This flows down from the five executive directors to the employees as part of a General Bonus Scheme.

For the current price control period, Network Rail has also utilised a ring-fenced fund (RFF). This means that they have the ability to defer any lower priority expenditure programmes if there have

[6] There is not a direct link between types of corporate vehicle and financial objectives – companies limited by shares, for example, could be Not-for-profit-distribution, but generally companies limited by shares are for-profit and companies limited by guarantee are Not-for-profit-distribution.

been cost overruns in other areas. Any financial surpluses that the company makes meanwhile are reinvested in the company or are used to service debt.[7]

The company's Board must abide by stringent corporate governance standards, as would be case for a company limited by shares.

The Board governs the strategic direction of the business, oversees operational management and takes control of financial performance, internal controls and risk management of the company. At the AGM, there is voting on the appointment of directors and external auditors, plus a review of the annual accounts. Voting is done on a one vote, one member basis.

The board runs Network Rail to the standards required of a publicly listed company (PLC). The company also produces an Annual Report and Accounts and holds an Annual General Meeting (AGM). Network Rail also publish a business plan, known as the Delivery Plan, each year

There are a range of sub-committees that exist within Network Rail, having been delegated certain powers and responsibilities. One example of this is the Nomination and Corporate Governance Committee, regularly reviewing the size, structure and composition of the Board. Nominations for Board members are also made by this Group, with the Board having final approval.

There are several ways in which accountability is ensured for Network Rail[8]:

- **Regulatory Regimes** – for economic and safety performance;
- **General Law** – for company, health and safety, competition and contract law;
- **Contracts** – with customers and funders;
- **Financial Requirements** – ORR have periodic reviews to set income;
- **Network Capacity** – ORR approve access contracts; and
- **Operational & Technical** – rail industry codes.

3.3. Conclusions

The table below sets out approaches to ensuring effective governance under a CLG structure as compared to a company limited by shares institutional framework. This is partly drawn from the Network Rail example above.

[7] ORR (2012) 2013 Periodic Review: Advice to the Secretary of State for Transport on Network Rail's Costs and Outputs in CP5, 15th March 2012. Available at: http://www.rail-reg.gov.uk/pr13/PDF/pr13-advice-to-ministers-ew.pdf
[8] Network Rail website: http://www.networkrail.co.uk/aspx/5619.aspx

Table 3.1: Approaches to ensuring effective governance

Approach	**Companies Limited by Shares**	**Company Limited by Guarantee**
Shareholder monitoring and dispersed ownership	Dispersed incentives across several shareholders in a company limited by shares can be countered by one entity, such as a strategic investor, having special governance rights and executive responsibilities. Shareholders can also coalesce into block holdings with membership arrangements and representatives.	While groups of members might make coordination easier, it perhaps erodes the collective interest that is central to the mutual structure.
Creditor monitoring	Lenders to a company limited by shares are likely to take significant steps to determine the use of the funds they provide, the cash-flows arising from those investments and the sustainability of the loans made. This requires *ex ante* due diligence and *ex post* monitoring.	Given CLG's are generally debt financed, lender scrutiny can be key. However, this might be diluted by guarantees on the debt. In addition, incentives for oversight from lenders are strong only when the company is distressed and more limited during normal operations.
Corporate control and takeovers	The ultimate means of control for managers in private ownership are those incentives provided by the possibility of corporate takeover and enforced changes in management.	Within a CLG the process for selecting members might mimic this to some extent and these members control the Board composition.
Stock options, long-term incentive plans and employee profit sharing	There are a variety of equity-based incentive schemes possible for managers in a company limited by shares.	Management Incentive Plans (MIPs) for CLGs seek to mimic these incentives.

Source: CEPA, TPA and ESP analysis

4. IMPLICATIONS/DISCUSSION

There are several lessons that can be taken from the comparator analysis presented in the two previous sections:

- **Profit/ not-for profit**: With the exception of ElectraLink, the comparator models used are all non-profit. This does not mean that funding necessarily match costs, just that the company does not pay a dividend. Any retained profit can then sit on the balance sheet to hedge against risks that they may face in the future. A non-dividend paying company appears to be the preferred approach here for dealing with industry owned central service providers.
- **Structure**: While MRASCo, ElectraLink and Elexon are Companies Limited by Shares, the CMA is a CLG. CMA went live in 2008 and the membership of the CLG allows flexibility and may have a better corporate framework for a non-profit company. A nominal share ownership in a not-for-profit organisation and a CLG though do not differ significantly.
- **Companies Limited by Guarantee**: following from the discussion on structure, CLGs have increasingly been used within infrastructure sectors to support the governance, funding and delivery of critical utility services. The CMA is the most direct comparator to Xoserve, however, Network Rail and Dwr Cymru Welsh Water (both CLGs) also illustrate that a CLG structure can support multi-million pound investment programmes provided effective supporting funding arrangements are in place.
- **Ownership:** Elexon is nominally owned by National Grid, but the funding obligations and risk allocation is placed on BSC parties. National Grid is also able to get recompense from Elexon should they incur any corporation tax liability or chargeable gains that would not have been incurred without Elexon ownership. MRASCo is set up with each MRA party owning one share each, as is the case with SPAA Ltd. CMA is a CLG with each Licensed Provider and Scottish Water as members. The implication from the Elexon model is that ownership can be divorced from control. If a Central Service Provider were being set up from scratch, aligning ownership and control would be preferable, but it is possible to have notional ownership that is separate from control, with control then aligned to funding.
- **Outsourcing of services**: MRASCo and the CMA in Scotland both act as 'thin' bodies, outsourcing the entirety of services to an appointed service provider (Gemserv). This means that in general the performance risk lies with the service provider and the existence of a contract imposes some competitive pressure on this organisation. In the case of the CMA, Gemserv in turn is allowed to outsource any of its obligations. We note that Xoserve already outsources some of its obligations to other providers, but full outsourcing as demonstrated through these comparator organisations is also possible.
- **Intellectual Property (IP)**: Despite the CMA outsourcing its service provision to Gemserv, it still retains the intellectual property rights and ownership of the systems. It is important to

consider the IP when establishing a cooperative central service provider in the gas industry and this will be affected by arrangements that are already in place.

- **Contractual arrangements:** Gemserv's contract with the CMA can be terminated with two months notice. For MRASCo, the initial Gemserv contract was three-and-a-half years. This adds competitive pressure and allows the outsourcing of performance risk.
- **Incentives for efficient delivery:** The CMA contract with Gemserv allows for bonus payments, should the cost per switch be below set bounds. This adds an incentive for efficiency in case the contract in itself does not create the level of discipline intended. This could be more difficult with a more complex service delivery plan, such as Xoserve, as opposed to the CMA for example, but incentives can be worked into a contract model to incentivise those in control of the company. In the case of ElectraLink, Clause 5.1 of the DTSA requires ElectraLink to procure services in the most efficient and economic manner.
- **Market audit:** The CMA has an external Market Audit every two years to ensure that operating costs are not excessively high, using benchmarking and other market evidence. In the case of ElectraLink, a shareholder is able to call for an external audit at any point. This adds both transparency and acts as a control mechanism for a service provider that knows its costs will be subject to a degree of certainty.
- **Transparency:** The services agreement between the CMA and Gemserv is a public document. This transparency may be seen as an incentive to contain costs and this fits together with having a market audit to put cost data into the public domain.
- **Budget determination:** For the CMA, the Board is responsible for the budget, while the Panel also provides a view on this and feeds into the process. For MRASCo, the Executive Committee develop the budget, while the Forum made up of all parties, approve this budget (this is the same for SPAA Ltd). The Board seems like the most appropriate entity to have ultimate control over the budget, but having other groups feed into the process appears more inclusive.
- **Role of the Board:** In the case of Elexon, the Panel has approval over the business strategy, whilst the Board has approval over the budget. While each party will have the right to give a view on both elements, effective control of the company's functioning is split. In the case of ElectraLink, the Board are responsible for the strategic direction, development and operation if the company, approving the annual budget and expenditure proposals amongst other things. A representative Board controlling both the budget and strategy appears a sensible solution in the case of a Central Service Provider in the gas industry.
- **Overlap between Board and Change Management:** With the CMA there is an overlapping Chairman of the Board and the Panel to try and ensure consistency and continuity.

- **Board size:** Both Elexon and the CMA have five-people Boards currently. It is set out that the Board can be flexible in size with no maximum number, but a minimum imposed. The MRA Executive Committee is comprised of four members, while SPAA Ltd's Executive Committee has seven members. ElectraLink's Articles of Association were revised in 2010 to allow up to nine members, with a minimum of four.

- **Board membership:** In the case of Elexon, there are five Board members. Three of these members are independent, with two industry representatives. This may be a positive step in that the Directors are focussed on running an IT services company rather than just representing their company in a different role. The Directors are also indemnified by Elexon through the Articles of Association. The appropriate balance between independents and industry representatives as voting members is an important consideration here.

- **Regulatory oversight:** In the case of Elexon as it currently stands, Ofgem appoints the Chairman of the BSSCo Board. Other areas of regulatory governance could be step-in-powers or budget oversight. Generally, the comparator models exhibit "light-touch" regulation and Ofgem does not have a role in the budget setting process, unlike the current arrangements for Xoserve.

- **Use of sub-committees and expert advice:** The MRA Executive Committee is able to delegate its powers to sub-committees. This is also the case for Elexon and Gemserv in the CMA example. The use of sub-committees including industry experts could be a mechanism whereby the Board approves proposals put forward by such groups. There may also be the potential for management to procure expert advice where necessary.

- **Constituencies:** Different constituencies have been created for each organisation. In the case of SPAA Ltd, there are five different constituencies created. In the case of the CMA, there is a split between Licensed Providers and Scottish Water. A potential problem with many constituencies is that it may reinforce the role as a representative rather than the Director of a services company.

- **Term for Directors:** In the case of Elexon before the contract model, the Directors have two-year terms, while the Chairman has a three-year term. With the CMA, there is a fixed term of up to three years for the Non-Executive Directors. The term lengths will affect the degree of continuity within a company and the timing of appointments will also have an effect if all Directors are replaced at the same time of the year.

- **Knowledge retention:** Within the CMA's service agreement with Gemserv, there are provisions for the CMA to become the employers of current staff should the contract between the parties be terminated. This is a given amount for each person.

- **Voting methodology:** For the CMA, the voting system for Directors is a preference vote, whereby the votes of eliminated nominees get transferred until two remain. The voting methodology may be dependent on the terms for Directors, but a preference voting system may give more acceptable results to all parties. There may be different voting methods for each constituency and it may be appropriate for the constituencies themselves to determine this, perhaps subject to approval.

5. CONCLUSIONS

Our comparator review demonstrates that there are many different models available for a central service provider supplying the services that Xoserve delivers.

To a large extent, the implication points from our review as listed above, can be thought of as individual building blocks for funding and governance arrangements whilst remembering the need for internal consistency (a core design principle discussed in the main report) which mean that in some cases individual building blocks may not be independent of other choices.

The models adopted must be appropriate for the tasks that they face and in the case of Xoserve, a transition to more cooperative arrangements provides an added layer of complexity as compared to other central service providers, such as the CMA in Scotland, that were established as new entities.

One of the key findings which emerged from our comparator analysis is that the utilities industry (albeit to different degrees) has increasing moved towards a central service provider model in relation to systems and processes that utilise common data and provide similar or identical services built around the processing of those common data. These businesses are often required to operate very transparently in the delivery of both their regulated and more commercial based services to a range of industry stakeholder groups.

Different funding and governance arrangements have been applied within this overall service delivery model. However, given the criticality of the services being provided, there is often a degree of regulatory oversight and control, although other comparator models in general have a lighter touch regulatory framework as compared to the existing arrangements for Xoserve.

Aligned with this lighter touch regulatory role, several decisions with regards the organisation of the central service provider are determined by those in control of the organisation rather than primarily through a regulatory authority. The supporting governance frameworks help to facilitate industry change and decisions to be made by the parties who control the central service provider and the services which are being supplied.

APPENDIX 1: NOTES ON COMPARATOR MODELS

Central Market Agency (CMA) Scotland: Governance, Ownership & Funding

Background

In April 2008, retail competition was introduced in the retail water sector to permit all businesses to be able to choose their retailer. Scottish Water are a public corporation who are accountable to the Scottish government. The cost of the service is set by the Water Commission for Scotland ('Commission'), with benchmarking taking place to compare with English and Welsh water companies.[9]

The Central Market Agency (CMA) receives data from market participants and each month determines how much suppliers should pay to Scottish Water in wholesale charges. The rules are set out in the Market Code and Operational Code. In September 2006, they issued an invitation to negotiate with service providers in advance of an April 2008 Go Live date.

Corporate structure

The CMA is a not-for-profit company. It is a company limited by guarantee (CLG) and is owned by its members (currently Scottish Water, Business Stream, Osprey, Wessex Water Ltd, Aimera and Severn Trent). These suppliers (i.e. the above list except for Scottish Water) are defined as Licensed Providers within the code. Scottish Water owns and operates the network of water and sewerage pipes in Scotland as wholesaler in the market. They sell water and sewerage services to the Licensed Providers in exchange for a wholesale charge. Each firm must offer a 'default tariff' to businesses that is the same as what the cost would have been without retail competition. Suppliers therefore differentiate themselves on billing, customer service and meter readings. Households meanwhile are served by Scottish Water.

The CMA contracts out its duties to Gemserv, while retaining ownership and intellectual property rights to the systems. The Service Providers retain perpetual access to this software though. Gemserv set out the rules to be implemented around switching and undertake this process. They were then appointed to build the central systems required to support customer switching, volume allocation, charge calculation and information flows between the CMA and market participants.

Gemserv is allowed to subcontract any of its obligations under the service agreement and then manage the contracts to third parties and associated risks. The role of Gemserv was broken down into a Phase 1, setting up the CMA, and a Phase 2, managing the operations of the CMA. Their role covers market design, delivery solution design, system operation and management, implementation tasks and a range of other general requirements due to the fullness of the outsourcing.

[9] There was also the option for a self-supply licence independent of the Licensed Providers, meaning you would buy water and pay for sewerage from the wholesaler, Scottish Water. This would also involve the responsibility for billing and meter reading. Examples of this would be large businesses who feel as though they would benefit from avoiding the Licensed Providers.

Costs

The set-up costs of the CMA were approximately £2.5m. These costs were included within the price control with Scottish Water up until the end of March 2008. In terms of ongoing costs, an approximate breakdown, as contained in the annual Business Reviews, is IT infrastructure at 50% of total costs, staff costs 30%, office and administration 10% and technical support 10%. The company accounts show a turnover of c.£3.1m in 2011/12 against operating expenses of £2.4m. Post-tax, there was an operating profit of £541,625 (2010/11: £122,628 profit).

Staff costs amounted to £522k for an average of 8 employees. Operating lease costs were c.£20k. In May 2012, the Board decided to return the current year operating profit of £69,826 to market participants in line with the Cost Recovery section of the Market Code.

In terms of financial risk, Gemserv indemnifies the CMA against all claims and there is a business continuity plan and security plan that is updated on regular interval. There is limited liability for the service provider of £4m p.a. (as of the initial contract), which is greater than overall turnover. The contract between Gemserv and the CMA can also be terminated with two months notice. In the case of termination, the CMA has the option to offer an employee or subcontractor of Gemserv a job with a fee to Gemserv of £10,000 without being liable for breach of contract.

There is also a Market Audit that takes place every two years to make sure that they are delivering the services effectively, while there is a contract in place to try and bring a competitive tension to ensure this. Within the service agreement contract, there are incentives for delivery charges per switch below certain levels.

Corporate governance

The organisation is run by a Board, who are responsible for the running of the company, including approving a budget. There is also a Technical Panel ('Panel') who take decisions on proposed modifications to the Market Code.

The Board is comprised of five members; a Chairman, Chief Executive, a representative from Scottish Water and then two nominated representatives from Licensed Providers. The first three of these members are recommended by the Commission. A nomination process takes place for the Licensed Provider representatives. Each Licensed Provider can nominate one individual. The nominated individuals are listed on a ballot paper. The Licensed Provider is then given this paper and lists their order of preferences. The candidates are then assessed on a first preference vote and the person with the lowest number is eliminated. Their vote is then reallocated to their second preference following the elimination of their first preference. This continues until there are two nominated individuals remaining. Removal is by unanimous approval within the fixed term.

All Directors are Non-Executive Directors (NEDs), apart from the Chief Executive. The NEDs are appointed for a fixed term up to three years and may be reappointed after this point. The Chairman must ensure that at least two NEDs remain on the Board at any time. There is a minimum of four Directors required, but no maximum to this number. The Directors can appoint and remove both the Chief Executive and Company Secretary.

The role of the Board is stated as follows[10]:

- Authorise the approval, removal and remuneration of the Market Auditor and agreement of an audit plan;
- Approve the CMA Budget and proposed CMA Charges;
- Review and approve any Market Audit Reports;
- Confirm satisfactory completion of Market Assurance Processes by any Trading Party;
- Provide a forum for discussion among Code Parties regarding the operation and development of the Central Systems and the Market Code;
- Report to the Commission and the Market Auditor on the activities of the Board;
- Authorise enforcement action in respect of a Trading Party or authorise the issue of a Termination Notice to a Trading Party; and
- Approve reports and the release of data in accordance with the Market Code.

The Chairman of the Panel is the same as the Chairman of the Board. The Chief Executive of the Board will also attend Panel meetings, but neither will be allowed to vote on matters.

The members of the Panel include a representative from each Original Applicant. Their role is to[11]:

- Keep the contents of the Market Code under Review;
- Consider and vote on any Market Code Change Proposal and/or Operational Code Change Proposal;
- Consider and provide its own views on Commission Change;
- Consider and provide its view on the draft CMA Budget; and
- Receive reports on compliance from Code Parties.

Any matter to be decided is decided upon by a Qualifying Majority dependent on the number of attendees at a vote. If there are one or two representatives, then this must be unanimous. For four attendees, this is three, rising to four for five or six attendees. The Commission has the authority to block any Panel decision to approve any Change Proposal.

A Market Code Change Proposal can be raised by any Trading Party, the Panel or the CMA Board.

The Panel can require Impact Assessments and a consultation, but are not obliged to do so. The Panel secretary will provide a Final Report on each Change Proposal.

There is a Annual General Meeting that includes the consideration of accounts, balance sheet and Director reports, the election of Directors to replace retirees and fixing auditor costs.

[10] CMA (2012) Market Code v21Section 8.4
[11] CMA (2012) Market Code v21 Section 8.6.6

Funding

The costs of the CMA are contained within an annual budget. One third of the costs are recovered from Scottish Water, while the remaining two-thirds is recovered from Licensed Providers. The share for each Licensed Provider of this figure is determined by its proportion of Meter Wholesale Charges (dividing its figure by the total aggregate amount). This is set out in Schedule 21 of the Market Code.

If the profile of costs is significantly uneven, the CMA Board is allowed to adjust the profile of cost recovery to reflect this, rather than a fully smoothed figure across the year.

MRASCo: Governance, Ownership & Funding

Background

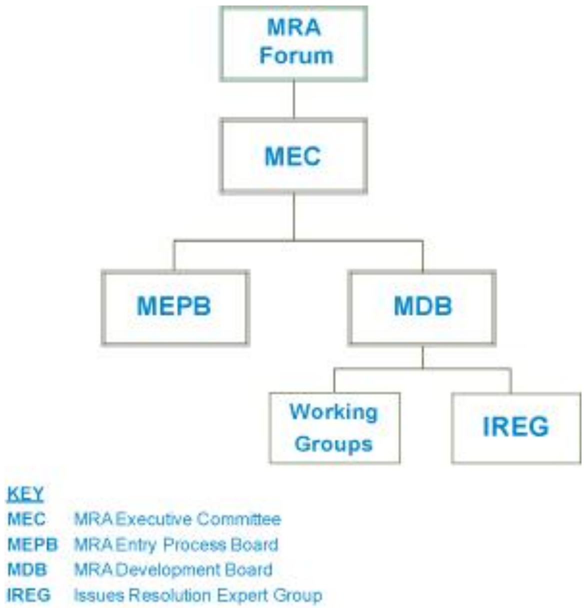
The Master Registration Agreement (MRA) was developed in 1998, following the opening up of the GB electricity market. The MRA itself is a multi-party agreement between licensed electricity distribution operators (DNOs), suppliers, the BSC agent and the MRA Service Company (MRASCo) enabling the transfer of customers between electricity suppliers. MRASCo adminster and undertake development activities relating to the licence requirements (SC37) to establish and maintain a data transfer service as part of the MRA. MRASCo is jointly owned by the MRA parties, with each party owning one share.

Service provision

From 1998-2002, MRASCo provided their services 'in-house.' MRASCo were only permitted to conduct services relating to the MRA, leading to a contracting model being established in 2002. Gemserv was established by MRA parties in a joint-venture, not-for-profit company (as is MRASCo), which would conduct all MRA services and also take on MRASCo staff under TUPE regulations. A Service Agreement was put in place to ensure the same cost obligations for the MRA parties as had been the case for using in-house services. There were also provisions for services to be taken back internally within the contract period (initially three-and-a-half years) and no obligation to continue with Gemserv as the service provider. Gemserv also undertakes services to other UK parties and overseas.

MRASCO Organisation

The structure of MRASCo is contained in the Figure below.



MRA Forum

The MRA Forum is intended to act as a forum for representing the views of parties, informing the parties on the operation of the Services and the MRA and to determine any matters referred to it by the MEC.

Each Distribution Business and Supplier is entitled to send one representative to attend any MRA Forum meeting. The BSC Agent (Elexon) is also entitled to one representative. Each representative has the right to speak and vote at these meetings, with the exception that the BSC representative is only allowed to vote on resolutions that relate to or affect the BSC Requirements (self-determined).

The first meeting of the MRA Forum takes place after April 1st each year, with a Forum Chairman elected by simple majority of those at the meeting. The Chairman is not entitled to any casting vote in that role. There is a minimum requirement with relation to attendance (i.e. a quorum) of at least 50% of the Distribution Business representatives on a Weighted Vote basis (see the Weighted Vote section below for details), at least 50% of Supplier representatives on a Weighted Vote basis, and attendance of the BSC representative where required. A resolution will be carried with support of the majority of these groups at each category level (i.e. Supplier and Distribution Business).

The BSC Agent may appeal a decision from the MRA Executive Committee (MEC) to the MRA Forum. A BSC Agent can appeal the MRA Forum decision to GEMA and consequently the Competition Commission. A MEC member may also appeal a resolution that is not passed, or appeal a passed resolution if it may unfairly prejudice the interests of that party or cause a breach of the MRA.

MRA Executive Committee (MEC)

The MEC has a range of powers and duties. A summary of these responsibilities are given below[12]:

[12] MRASCO (2012) Master Registration Agreement v9.7, Section 6.2.

- Consider any proposals to change the MRA, of which unanimous approval is required to approve a change with written approval from the regulator;
- Consider any changes to the Data Transfer Catalogue (DTC);
- Consider applications from potential New Parties;
- Develop budgets;
- Hire any professional advisors;
- Check and notify parties that they are defaulting parties;
- Resolve disputes between parties;
- Consider and grant derogations;
- Undertake to provide further funding for other relevant industry bodies;
- Consider Operational Issues and make recommendations;
- Approve and authorise licensing and sub-licensing dealing with Intellectual Property;
- Monitor and manage the performance and day-to-day operation of any Services Agreement.

MEC membership is comprised of the following representatives; i) 1 MEC member appointed by the Distribution Businesses, ii) 2 MEC members appointed by the Suppliers, and iii) 1 MEC member appointed by the BSC Agent.

In terms of putting forward candidates, each Distribution Business and Supplier may propose one candidate for election. The number of votes each party has is in relation to a formula, as noted in the section below.

If the majority of parties agree in either the Distribution Business or Supplier categories, the MEC member in that category can be removed from office at any time.

The MEC Chairman shall be a MEC member and be appointed by a simple majority of MEC members. A majority of MEC members can also remove the Chairman from office at any time. The MEC also has a secretary, who is appointed by a resolution of MEC members and is entitled to speak, but not to vote on any issue at the MEC or MRA Forum meetings. The MEC meetings must take place at least every three months.

The Data Transfer Service Controller is allowed to send a representative to any meeting that discusses a change to the DTC. Any MEC member is also allowed to invite a person with technical expertise in an area to speak on such an issue. The MRA Development Board (MDB) is a sub-committee of the MEC. The MEC can formally delegate its power to these sub-committees or choose to ratify the decision.

Weighted Voting System

For Suppliers, the percentage of the vote involves dividing the number of Registered Metering Points from the Supplier, by the total number of Registered Metering Points from all Suppliers. For Suppliers with no Registered Metering Points, a figure of 1 is taken, so there is some representation of such parties (i.e. prospective new parties).

If any Supplier has over 20% of the Total Weighted Vote, the additional percentage is reallocated in accordance with the methodology given above.

For Distribution Businesses, there are different calculations for those with over 750,000 Registered Metering Points and those with less than this number. For those with over this threshold, the percentage of vote corresponds to the calculation for Suppliers. For those with under the threshold, the remainder of the vote, after taking into account the calculations of the companies above, is split equally between each firm under this threshold.

Funding

The MEC is entitled to recover all its reasonable costs and expenses associated with the MEC, MRA Forum and the Secretariat (those providing support services to MRASCo). They are also able to recover the costs of consultants or advisors retained by the MEC and the costs of ay industry body specified by the MEC.. An annual budget is approved by the MRA Forum, comprising all parties to the MRA. The structure of the arrangement is that all parties apart from the BSC Agent should jointly and severally indemnify MRASCo and its constituent parts.

Cost recovery follows rules for Suppliers and Distribution Businesses. All Suppliers, and Distribution Businesses with under 750,000 Registered Metering Points, face the same formula, with the costs incurred over the previous quarter calculated as follows:

$$P = \frac{A \text{ x } B}{C}$$

Where;

P is the amount due from each Supplier or Distribution Business;

A is the average number of Metering Points of the Supplier or Distribution Business over the last three months;

B is the estimated costs for the quarter of the Supplier or Distribution Business category included in the most recent approved budget (two-thirds of the total budget is allocated to Suppliers, one-third is allocated to the Distribution Business), and;

C is the average number of Metering Points contained on all Supplier or Distribution Business registration systems over the last three months.

The remainder of costs are split evenly between Distribution Businesses with over 750,000 Registered Metering Points.

Code Governance Review (CGR)

An aspect that Ofgem are trying to change with the CGR is to increase consistency across codes and to introduce a set of objectives for the MRA, which is currently the only network code without such objectives. Ofgem's proposals are for the MRA to adopt the same objectives as the Supply Point Administration Agreement (SPAA).

There are also additional changes recommended by Ofgem in the CGR, largely to increase consistency between codes and improve transparency, including:

- Introduce a Significant Code Review process;
- Implement a Code Administration Code of Practice (CACoP) for consistency across codes;
- A 'critical friend' established in the role of Code Administrator, who shall:
  - Publish, review and amend the CACoP approved by GEMA
  - Facilitate the network code modification procedures
  - Have regard to and remain consistent with the CACoP
  - Provide assistance with drafting a modification proposal, understanding the operation of the uniform network code, helping represent a party during the modification procedure processes and accessing information in relation to modification proposals.
- Enable send-back powers for Ofgem to return final modifications for editing should a significant flaw be identified; and
- Reporting an assessment against relevant objectives to improve transparency.

Elexon: Governance, Ownership & Funding

Background

The Balancing and Settlement Code (BSC) was set up in 2001 in the England and Wales electricity market to check the balance of actual against contracted positions and settle any differences in this balance. All major electricity industry participants (over 200 parties) are signatories to the BSC.

The BSC Company (BSCCo) administers the BSC. The existence of the BSC and the BSCCo (as code administrator) are the product of a licence requirement on National Grid Electricity Transmission ("National Grid"), which is the sole owner of Elexon Limited ("Elexon"). Since the creation of the BSC, Elexon has acted as the BSCCo. It is important to note that although the BSCCo is a registered company, in practice everything has been done through Elexon Limited and the distinction between the two companies has been immaterial.

Elexon is a non-profit company with National Grid the sole shareholder in the company. National Grid does not, however, operate as a normal owner as it maintains purely notional ownership. The funding of Elexon is also the sole responsibility of the BSC members, and National Grid bears no liability in this respect.[13]

The core mission of the BSCCo is to 'deliver the BSC effectively, efficiently and economically, to the benefit of [our] customers.'[14]

Ownership and Management

National Grid Electricity Transmission (NGET) is the sole owner of Elexon, which has a licence requirement with respect to the functioning of the BSC The BSCCo Board duties include approving the annual budget, monitoring performance and ensuring effective cost control.

The Board is comprised of:

- 1 Independent Chairman
- 2 'Industry' Directors who are also BSC Panel members (the Panel elect these members to the Board)
- 2 Directors nominated by the Chairman in consultation with the Panel.

All directors are non-executive and have initial two-year terms. The Chairman serves for three years.

Services

Duties covered within this role are to handle trading disputes, administer BSC change processes on behalf of the BSC panel and enforce performance standards. Elexon also procures and manages service contracts (e.g. IT) with third parties.

The responsibilities, powers and functions set out in Section C of the BSC cover the following[15]:

(a) entering into and managing BSC Agent Contracts for the supply of the services required by BSC Service Descriptions (covered in Section E);

(b) advising the Panel on matters that the Panel should consider in order for the Panel to discharge its functions and responsibilities;

(c) providing facilities, resources and support required by the Panel, Panel Committees and Modification Groups (including secretarial and administrative services and the provision of a Panel Secretary);

(d) providing and making available to Parties facilities, services and information associated with the implementation of the BSC that may be required by the Panel or provided for by the BSC;

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[13] Ofgem (2012) Diversification and Governance paper

[14] Elexon (2011) BSCCo Business Plan 2012-13

[15] Elexon (2010), Section C of the BSC

(e) entering into contracts of employment or other terms of engagement with the Panel Chairman and the independent Panel Members appointed by the Panel Chairman (as outlined in Section B);

(f) indemnifying and reimbursing the expenses of Panel Members, Panel Committee members, Modification Group members and others as provided for in the BSC;

(g) entering into Accession Agreements with new Parties (covered in Section A);

(h) acting as BSC Agent under the Master Registration Agreement (MRA) (covered in Section K);

(i) acting as shareholder of ELEXON Clear;

(j) collecting and holding data and information, and maintaining books and records, as necessary to enable ELEXON to comply with its functions under the BSC or as is otherwise required under the BSC, and to providing data and information held by it to the Panel on request or to other persons as provided for in the BSC;

(k) where it is not the job of a BSC Agent to do so, maintaining records of the extent to which Parties have satisfied the requirements to undertake certain registration activities prior to exercising any right under the BSC (as covered in Section A) and to provide details of these records to others as provided under the BSC;

(l) monitoring whether any Party is or will be in Default and giving notice of Default (covered in Section H);

(m) acting as the Performance Assurance Administrator (PAA) (covered in Section B);

(n) making recommendations to the Panel on possible modifications to the BSC where the BSC provides for ELEXON to do so (outlined in Section F); and

(o) preparing and/or assisting the Panel in preparing the Annual BSC Report (covered in Section B).

BSCCo Panel

The Panel Chairman is appointed by Ofgem (more specifically GEMA). The members are:

- 1 Chairman
- 5 Members elected by Trading Parties
- 2 Members appointed by the National Consumer Council
- 1 Member appointed by National Grid Electricity Transmission
- 2 Members appointed by the Chairman that pass independency criteria
- 1 Member appointed by the Chairman as a further industry representative

The election of the five members by Trading Parties takes place every two years, with terms expiring every two years (latest term is from 1 October 2012). Each trading group receives one vote. An election is not required in the case where there are five or less proposed members, as was the case with the 2012 elections.

The decision to vote is at the request of any Panel member, which will usually take place at the monthly Panel meetings. Voting is decided by a simple majority with the Chairman having the deciding vote in the case of a tie. The member appointed by NGET do not possess a vote in relation to any Mod proposals.

There are parties that are allowed to attend and speak, although not vote. This includes a GEMA representative, a Distribution System Operator representative and the Chief Executive of the BSCCo.

BSCCo Budgeting

Elexon operates as a non-profit-making company; its charges are set only to enable it to recover its costs. Though owned by NGET, the financial liabilities fall on the parties subject to the BSC. NGET must transfer their shares to any successor, determined by GEMA. The overall finances are described at a high level in the diagram below:

Figure 1: BSCCo Budget Summary

	Year to March				
Item	2012 Budget £m	2012 Forecast £m	2013 Budget £m	2014 Projection £m	2015 Projection £m
ELEXON Operational	17.2	16.0	16.0	16.2	16.7
Demand Led	1.4	1.0	1.5	1.6	1.6
Contracted	13.9	13.6	14.2	13.9	13.2
Total Regular Activity	**32.5**	**30.6**	**31.7**	**31.7**	**31.5**
Market Development	3.0	1.0	2.0	1.3	1.0
Governance & Vires	-	-	1.5	-	-
Overall Total	**35.5**	**31.6**	**35.2**	**33.0**	**32.5**

Elexon levies a charge on all of the BSC parties, with charges charged based on a combination of the unit charges that depend on the services used, and their respective role in the market (e.g. the parties' level of generation or supply). The services for which BSC parties are charged are specified in the BSC; each year the BSC Panel publishes the charges that will apply over the coming financial year – both the fixed and per unit charges.

Elexon was previously restricted to carrying out activities that are specified in the Code. Elexon have began diversifying by taking on the responsibility to establish and operate a reconciliation scheme for the Warm Home Discount Scheme.

In making its decision for this, Ofgem attached a number of preconditions:

- Appropriate cost allocation methodology – In carrying out new activities Elexon must ensure that any costs arising from the provision of non-BSC services are recovered from the customers of the services. Therefore, Elexon will need to put in place a mechanism to ensure an appropriate allocation of costs between BSC activities and the new Elexon activities.
- Ring-fencing arrangements – As Elexon takes on new activities it is possible that it will face commercial risks that could place risks on its ability to deliver the BSC services. Therefore Elexon will likely be prohibited from using BSC revenues or assets related to BSC activities as collateral for loans or to fund other activities. Arrangements will need to be in place to ensure that if there are any problems in Elexon's ability to deliver the non-BSC services, someone else will need to be able to step in to ensure service continuity.
- Commitment to maintain existing standards of performance for BSC services – Elexon will have to commit, potentially in a contract, to maintaining standards at an appropriate level.
- Elexon's new role should not give it an undue advantage in the DCC competition – In allowing Elexon to provide other services, there is a risk that Elexon would be able to use BSC funds to gain an unfair advantage in a competitive process (such as the DCC bid) or risk creating a cross subsidy. Ofgem is therefore expecting Elexon to put in arrangements for the transparent and equitable allocation of common costs between BSC activities and any new activities that Elexon might undertake.

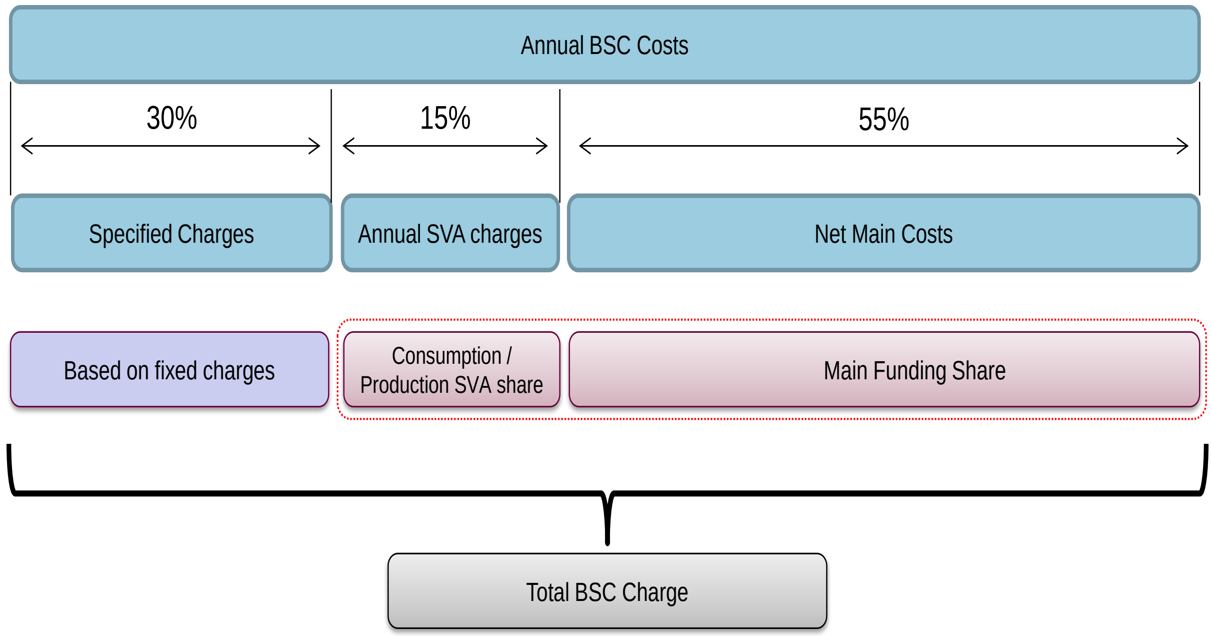
Elexon currently operates as a non-profit-making limited liability company that was established to facilitate the operation and development of the electricity trading arrangements for all the different parties to the Balancing and Settlement Code (BSC).

Given its not-for-profit status, Elexon applies charges to the BSC parties to enable it to recover the operational and development costs that it incurs as it governs the BSC. The amount for which each party is liable is determined based on their respective market role and the amount of electricity that they generate.

Breakdown of Elexon's costs

Figure 4 below provides a breakdown of how Elexon's annual costs are recovered each year.

Figure 4: Breakdown of Elexon's annual costs



The diagram does not include the default funding costs, which are not ordinarily incurred.

As Figure 4 illustrates, Elexon's annual costs are separated into three main segments:

- *Annual Supplier Volume Allocation charges* - which covers the operational aspects of the SVA system, and is split equally between generator and supplier parties. Generators contribute to the production half through the Production Charging SVA costs. Suppliers pay the other half through the Consumption Charging Net CVA costs and the SVA Specified charges (SVA specified charges are tariff-style payment for half-hourly meters). In total the annual SVA charges account for around 15% of the BSC costs each month.

- *Specified charges* – parties pay a fixed monthly amount for various things on a tariff basis. These includes a range of charges such as:

    - basic subscription charge (flat charge currently £250);
    - notified volume charge (£ per MWh);
    - the CVA Balancing Mechanism (£ per BM Unit); and
    - a metering system charge (£ per Central Volume Allocation (CVA) metering system.

  In total Elexon recover around 30% of their costs through the Specified charges.

- *Net main costs* – the remainder of Elexon's costs after deducting all other costs. In total this accounts for around 55% of Elexon's costs each month.

Annual default costs are any total unpaid amounts that Elexon treats as bad debt (based on the parties' general funding shares, calculated by ignoring the defaulting party – where the general funding share is the proportion of all BSCCo charges paid by the respective party). In addition to the above, individual BSC parties have to pay for any additional services that they procure from Elexon.

Elexon Specified charges

While the Specified charges determine the monthly amount that the parties must pay, as they are in part determined on a per unit basis, the remaining costs are recovered on a lump sum basis with each party's costs determined using the funding share calculation below.

Elexon funding share calculation

For each party Elexon derives a ratio based on the energy that the parties produce or consume in a month. Parties that generate or supply more will pay a larger share of the costs. The funding shares are:

- The Main Funding Share, which is applied to the net main costs.
- The SVA Production Funding Share, which is applied to the Production Charging SVA costs.
- The SVA Consumption Funding Share, which is applied to the Consumption Charging Net SVA costs.
- The General Funding Share, which is derived from the party's total payments.
- The Default Funding Share, which is applied to the any default costs.

Publication of charges

The rates for the Specified Charges and for the Main Charge are set by the BSC Panel at the beginning of each financial year, and are published on Elexon's website.

Section D of the BSC provides a more detailed explanation of Elexon's charges, including additional detail on the information that respective parties are meant to provide Elexon with to enable them to apply their various charges.

Emergency funding

If the BSCCo is unable to pay any BSCCo costs, they may, with approval of the Panel, give notice of a cash call to Trading Parties, where such parties must pay as per their main Funding Shares by a specified date.

Budget overspend

If actual expenditure from the BSCCo exceeds the Annual Budget, an explanation is required and a revision to the Annual Budget is required, with any possible options for modifying the business strategy in that year.

The text box below summarises how the existing funding arrangements treat a cost overrun of Elexon Ltd acting as the BSSCo.

Box A.1: How Elexon Ltd treats a cost overrun

Elexon are a company limited by shares. Costs are based on a budget, with monthly charges being set. These costs are invoiced one month in advance, such that Elexon maintains a cash surplus.

If there is any profit or losses in relation to Elexon funds, this amount is either offset or added to costs, which are then spread across the industry on the basis of Funding Shares i.e. the same manner as all regular costs.

Source: Elexon Treasury Policy

ElectraLink: Governance, Ownership & Funding

Background

ElectraLink is a private limited company which was set up in 1997/8 to deliver a Data Transfer Service (DTS) to underpin the domestic electricity supply market. It is owned by the 14 electricity distribution licence holders (six major groups). There is an obligation for electricity distribution licence holders to procure, manage, operate and support a data transfer service.

In additional to the regulated DTS, ElectraLink also undertake commercial services, including data management services, and secretarial, administrative and financial management services.

Board of Directors

In 2010, ElectraLink's Articles of Association were updated to give more flexibility around the size and composition of the board and its delegated authorities. The Articles set out that the Board may be as large as nine directors, but with a minimum of four directors.

The Board is currently comprised of a non-executive Chairman, four non-Exec directors and an executive director. The Directors have a three year term before coming up for re-election. The Board are responsible for the strategic direction, development and operation of the company, approving the annual budget and expenditure proposals. The Directors are able via the Articles of Association to delegate all or some of their power to outside parties.

In terms of voting for a Director, each ordinary shareholder is permitted to nominate someone for election, to take place at the Annual General Meeting, where each party will receive one vote per share. There are 10,001 ordinary shares, each valued at £0.10 each. Similarly, an ordinary shareholder is able to propose the removal of a Director.

DTSA User Group

There is a User Group set up to act as a forum for representing the views of Users. It is comprised of ten members; five appointed by suppliers, three appointed by distributors, one appointed by the BSCCo and one external member from a group not represented above. The constituent groups vote for a representative using a single party, single vote methodology. Members can serve for up to three years and the elections are timed such that all members terms do not expire at the same point.

Once the User Group members are elected, voting is by a simple majority of representatives present with the resolution not being passed in the case of a tie.

This User Group requested that necessary arrangements were made to ensure that certain data analysis services could be available to Users and other market participants on a bilateral, commercial and user-pays basis. As part of Schedule 9 of the DTSA, it states that the ElectraLink themselves should propose to Users and potential customers, data analysis services which may be commercially advantageous. This will leverage the knowledge of ElectraLink staff to the benefit of Users.

DTS and commercial services

The regulated DTS is detailed through the DTS Agreement (DTSA), which contains details on governing standards of service, liquidated damages, limits of liabilities, IPR ownership, change control and an Ofgem based charging methodology. There is also safeguarding to protect DTS users from facing the risks of ElectraLink's other commercial services.

In 2004, Ofgem granted consent to the DNOs to enable ElectraLink to operate in the gas and water sectors, carrying out certain unregulated data services and is currently seeking to further expand its activities beyond those set out in the licences, for example relating to DECC's Smart Metering Implementation Programme (SMIP).

These commercial services are largely provided to the users of the DTS service and are contained within contracts, e.g. Distribution Use of System billing and Review of Gas Metering Arrangements. ElectraLink has competitively won the contracts to govern the SPAA and DCUSA codes.

In terms of managing sub-contractors for the DTS, ElectraLink detail the required service levels, set out damages for non-performance and retain the IPR.

Funding

In terms of funding, the DTS Charging Principles do not allow for a profit on the costs they charge to the DTS, which are then 'pass-through' to DTS users, with ElectraLink only allowed to make a funding charge on the capital provided in order to bridge the timing difference between the DTS costs being incurred and their recovery via DTS charges. The DTS service is noted as essentially being a not-for-profit franchise in a consultation response from ElectraLink to Ofgem over such an expansion.

The charges that are set by ElectraLink are a mixture of User Charges and Supplier Charges. Each user will pay, as User Charges, a i) Service Standing Charge, ii) Charges for Traffic and Local Traffic sent by the User, iii) Charges for any additional services provided, and iv) an appropriate share of ElectraLink's admin costs. These charges are invoiced quarterly in advance. Supplier charges meanwhile allow ElectraLink to recover the costs of setting up and continuing to provide the DTS, including an appropriate rate of return.

In terms of paying dividends, it sets out that the Directors may choose to pay an interim dividend if it appears justified to do so out of company profits.

Costs are said to be clearly identified and charged to the service (profit or cost centre) to which they relate. All costs incurred for commercial activities are funded by the company's shareholders, while the fixed costs of the company are not material. In the case where the proposed draft budget leads to a dispute arising, the approval of the financial Budget for the next financial year must receive 75% approval. Changes to pensions will require Director approval also.

In terms of protecting DTS users from risks, any contract with an aggregate value of over £10m across five years, a value over £3.5m in one year, any borrowing over £500,000, or sale of IPR/ material asset rights all require ElectraLink shareholder approval. These shareholders would be obligated to provide funding to ElectraLink if so required.

In terms of ownership, share ownership is limited to licensed DNOs as set out in the company's Articles of Association and Shareholder Agreement. These Articles of Association also set out that the DNOs will provide £3.5m of funding if required to support the DTS.

In terms of other elements contained in the DTS, Clause 5.1 requires ElectraLink to procure services in the most efficient and economic manner, whilst DTS users have the ability to call for an external audit of the DTS charges at any time.

Recent outturn and future opportunities

As of the end of 2011, the company held working capital of £3.4m, with an annual turnover of £6.3m. In the previous three years the company paid an interim dividend to its shareholders of c.£350,000.

According to the 2011 annual report, ElectraLink needed to invest almost half a million pounds to respond to the requirement of Smart data transfer service requirements and the consequential impacts for the DTS. The company funded this work through reserves, but hope to have recovered this charge to company profits in future years under the DTS pricing formula (i.e. in relation to share size).

Profits from non-DTS commercial services partly offset the charge to profits from DTS required expenditure, but the company still made a loss of £120,000 pre-tax in 2011. Dividends were still paid in 2011 of £350,000 despite this loss. 'Business as usual' costs for DTS services were said to have come in under budget. There is ring-fencing such that DTS users are protected from losses incurred on commercial services.

Moving forward, the company identified (in their 2011 annual report) opportunities for growth in 2012 and beyond. The DTS was selected as the provider of data transfer services to the Green Deal and ElectraLink are involved with arrangements associated with the DCC, working across the entire electricity sector and the majority of the gas sector also. Green Deal parties are expected to accede to the DTSA from 2012 following on from ElectraLink's selection as service provider.

APPENDIX 2: REFERENCES

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