Morse Report Response

Executive Summary

ELEXON welcomes publication of Ofgem's open letter and Richard Morse's independent report (the Report) into ELEXON's future diversification and governance and the opportunity to submit a response.

We fully support the views expressed by Ofgem in its open letter that ELEXON should be permitted to undertake additional activities in delivering the critical market reforms affecting the energy sector and we welcome Ofgem's commitment to "…shortly consult on extending the vires of ELEXON Limited in order to allow it to carry out activities other than those associated with the operation of the balancing and settlement arrangements". We support the Report's conclusions which clearly underline the need for urgent action and proactive leadership from DECC and Ofgem to push forward the reform of ELEXON's current business structure.

Whilst we note that in paragraph 30 Richard states that "…None of the foregoing suggests that ELEXON"s desire to diversify cannot be achieved using the structure it has proposed" (albeit the Report believes we have underestimated the degree of negotiation required) this ELEXON response focuses on certain high level governance and ownership principles that underpin ELEXON's proposed model which in our view do not receive sufficient weight and emphasis in the Report. These principals are the following:

	ELEXON proposal	Report's alternative structure
Ownership and Control and use of profits	Broad community of members No ability to unduly influence Profits from new business to be reinvested in accordance with Group's stated aim, rather than be distributed to members	Narrow community of members The service company to be owned and controlled by those (few) BSC Parties willing and able to invest upfront as shareholders Profits from business (BSC and new) to be distributed to shareholders
Necessity and benefits of introducing a services contract	No immediate requirement for services contract BSC arrangements unchanged Costs of implementation and ongoing management to be evaluated but minimal Benefits - New business makes contribution to central overheads, reducing BSC Party costs	Services contract to include a profit element, but efficiencies to be incentivised Costs of implementation and ongoing management greater than ELEXON proposal Benefit - Re-procurement at end of initial term could lower costs;
Funding	Funding from willing BSC Parties and others to be repaid subject to successfully securing the DCC roles	Funding provided through monetising the profit element of the services contract

ELEXON

	ELEXON proposal	Report's alternative structure
Implementation	No services contract to negotiate so simpler Implementation achievable within 3 to 6 months	Assets to be allocated/ cap badged Resources (internal and external) required to negotiate services contract

We believe a services contract will increase costs, add an unnecessary additional layer into governance and introduce more demand on (internal and external) resources to negotiate a services contract at a time when industry resources are stretched and should be focused on delivering change.

We believe the issues of unlocking our vires and introducing a services contract are independent matters and can be implemented over different timescales, with vires being unlocked first to enable us to participate in key Government initiatives, followed by the introduction of a full contract (assuming Ofgem conclude a services contract is desirable). To implement a services contract before or simultaneously with unlocking vires will result in delay and our inability to comply with the timetable for government initiatives, in which case a services contract will have been introduced for no benefit.

Finally, any change to governance must be accompanied by a firm implementation plan with clear leadership from DECC and Ofgem.

Introduction

ELEXON welcomes publication of Ofgem's open letter and Richard Morse's independent report (the Report) into ELEXON's future diversification and governance and the opportunity to submit a response.

ELEXON met with Richard Morse on two occasions to assist Richard's understanding of the current BSC governance arrangements. Unlike the Standing Issue 40 report, we were not involved in its drafting and did not have the opportunity to review the Report in detail prior to publication. We are grateful for this opportunity to comment. We acknowledge the challenges faced by Richard in seeking to produce a balanced set of findings and note that in the time available he was only able to consult one BSC Party (E.On).

This response document does not comment on every paragraph of the Report indicating agreement or otherwise, other than to highlight where the Report is factually incorrect and where this may lead the reader to either misinterpret or misunderstand the Report's findings. However, we have taken the opportunity to provide further justification and background thinking for the governance arrangements that we have proposed, including in Appendix 1 a detailed description of our proposed new ownership and governance model prepared in early 2011.

We are keen to engage on some of the points raised by Richard and whilst the Report correctly identifies a number of detailed matters that will need to be resolved (and we look forward to working alongside BSC Parties, Ofgem and DECC to address these) we have focused on the different approaches to governance and ownership reflected in our proposal and the alternative in the Report, and the philosophical differences that arise therefrom.

Finally it is worth stating that of Richard's listed conclusions A-J, we agree with conclusions A, B, C, D, F, H and J. It is conclusions G and E with which we disagree (the introduction of a contract), and conclusion E which we believe unnecessary (the introduction of a Licence on BSCCo).

The philosophical differences

The Report (together with the discussions within Standing Issue 40) highlights a number of significant philosophical differences that go to the very heart of ELEXON's governance and ownership proposals and which we believe are not given sufficient weight and consideration in the Report. These differences coalesce in the following 4 areas:

a) Our underlying design objectives;

b) Ownership, control and use of profits;

c) Necessity and benefits of a services contract;

d) Funding and implementation.

Each of these areas is discussed below including references to the Report's findings where appropriate.

a) Underlying design objectives

In the approved 2011–12 BSCCo Business Plan we acknowledged that the market we operate in is subject to unprecedented pressure for change and how, as an acknowledged expert and experienced industry service provider we are well positioned to outline and pursue a vision of improved market delivery. We also signposted the need to amend our governance and vires such that ELEXON is able to extend its activities and to play a greater part in helping industry through this period of change.

The starting point for our reform proposals is a set of published design objectives that we believe meet the needs of all key stakeholders (BSC Parties, DECC, Ofgem and NGET) and represent best value for consumers, against which any of the structural options should be tested. The objectives of our proposed structural reforms are to:

- ensure that existing core BSC business services are maintained to high quality and to customer's reasonable expectations and that there is no dilution of necessary BSC resources and expertise;
- enable the creation of an appropriate corporate structure for existing and new activities of the ELEXON Group that supports current and future market developments and aligned with delivery of the Government's policies;
- provide for an appropriate legal and regulatory framework;
- maintain independence;
- allow for a fair reflection of current and future stakeholder interests;
- ring-fence liabilities, costs and risks for current and new activities;
- avoid any unfair competitive advantage; and
- enable appropriate funding.

It's our view that the significance of these factors is underplayed in the Report.

We defined the organisational purpose of New ELEXON as being: "the promotion, development and implementation of innovation, cost efficiency, improvements and rationalisation through the provision of regulated and unregulated services to the utilities sector for the benefit of industry, consumers, regulatory bodies and other legal authorities".

Accepting the constrained timescale for completion of the Report it is nevertheless disappointing that the Report's findings have not looked more widely at alternative governance structures e.g. in the gas and electricity markets and have drawn such close parallels with "the Gemserv model" which we do not agree with or support on the basis that it does not meet the objectives and purpose described above.

A detailed description of ELEXON's proposed ownership and governance structure, which was drafted in early 2011, is set out in Appendix 1.

Report observations

Para's 51 to 60: These paragraphs set out the perceived parallels between the current ELEXON situation and the MRASCo/Gemserv experience. We question these perceived parallels:

- the scope, size and complexity of the services provided under the respective arrangements (the MRA and the BSC) are significantly different and more appropriate parallels could have been drawn elsewhere, e.g. the arrangements that exist in the gas market;
- the community of customers served by the two arrangements are significantly different;
- the challenges of outsourcing to an independent entity are potentially significantly more complex, costly and lengthy than experienced under the MRA/Gemserv transition. This topic is considered further in Section c) below.

The Report asserts that Gemserv has been independent of MRASCo for 7 years. However, we question this where Gemserv and MRASCo have common shareholders and the contract between them has not been competitively tendered since being established in 2002.

b) Ownership, control and use of profits

Consistent with our overall design objectives and organisational purpose we firmly believe that the new ELEXON holding company (HoldCo) should be established as an independent "not for distribution" Company Limited by Guarantee (CLG) meaning that any profits generated within the group will not be distributed to its members. Instead, any retained profits will be utilised to further the group's overall purpose as set out above.

We do not believe that it is in the best interests of Government, current and future ELEXON customers and ultimately consumers, for HoldCo ownership and control to reside with a small and dominant community of industry players. For these reasons we developed the following membership principles:

- membership should be voluntary and constituted from the stakeholders that HoldCo will benefit; this should include current BSC stakeholders and stakeholders in potential new ELEXON Group activities;
- membership requirements must be sufficiently flexible to allow for additional parties to become members to reflect changes in ELEXON Group activities that have yet to be anticipated;
- the membership arrangements must not be capable of manipulation such that any one member is able to exert undue influence for its own financial or other benefit, to the detriment of other members;
- a member may resign on giving notice (and may be removed if they cease to satisfy the qualification criteria below or become insolvent etc);
- there is no minimum or maximum number of members and membership is non transferable;
- the community of members should provide appropriately skilled and qualified people from which non executive directors may be nominated.

The approach that is therefore proposed is to invite the following to be members of HoldCo:

- all holders of current licences issued under relevant electricity and gas legislation;
- all signatories to all gas and electricity industry codes; and
- relevant consumer representative organisations.

This approach to membership will ensure that the widest possible community of stakeholders can become members of the new HoldCo and hold it to account for its actions and services. Members will be entitled to participate in the decisions made by HoldCo via: (i) members' resolutions; and (ii) the nominations process for directors.

The New HoldCo Board will comprise executive directors and non executive directors. Non executive directors will include representatives of the members and of other stakeholders and interest groups. This is to ensure that members' interests are represented at the Board as well as other stakeholders. It also provides the opportunity for the Board to include individuals with specific desired experience which can be of benefit to the ELEXON Group.

Report observations

Para 27 Rationale for diversification: The Report states that ELEXON represents itself as lean and efficient but at the same time feels it has the capacity to diversify - we take issue with this implied contradiction. In support of our diversification ambitions we have stated that in our view the organisation's expertise, experience, and assets could be harnessed to support the transformational change that faces the industry. ELEXON has not suggested or proposed that this could be in some way absorbed within the organisation's existing capacity. What we have stated, and passionately believe, is that government and ultimately consumers should not be forced to pay more than is absolutely necessary, through the duplication of central market arrangements, where those arrangements already exist but cannot be leveraged due to an outdated governance framework.

Para 32: Our aspiration is to create long term value and to serve the widest stakeholder community, not to enable short term gain for those that can afford to invest equity. Rather than simply being "well intentioned" as indicated in Para 32 of the Report we see this approach as fundamental to maintaining ELEXON's position of independence and neutrality (including fulfilling our obligation as a "critical friend") and as a prerequisite for participation in Government's delivery landscape.

Para 34 to 38: The Report rightly identifies the historic and symbolic roots of the current ownership arrangements. The Report also acknowledges the arms length relationship that exists between NGET and ELEXON and the limitations of responsibility and liability tied to this arrangement. Para 36 in particular recognises BSC Parties as the "natural shareholders" of BSCCo but also acknowledges that in such an arrangement there is a risk that a "few bigger companies could own a majority of the BSC administrator [by which we presume Richard means the service company] to the detriment of the combined interests of the smaller companies". It seems to us that the arrangements proposed by ELEXON provide for the appropriate protections and mitigates this risk by:

- preventing one member or class of members unduly influencing the group;

- ring-fencing the BSC and BSCCo Board (we acknowledge that changes will be necessary to the composition of the BSCCo Board);
- ensuring that the new HoldCo cannot impose or encumber BSCCo and put at risk the services BSC Parties require under the BSC.

It is our view that these protections can be implemented through straight forward changes to the BSC and through the Articles of Association of ELEXON HoldCo and BSCCo.

c) The necessity and benefits of a services contract

Necessity

The Report raises a number of issues concerning the relationship between BSCCo and the other entities within the Group and in particular how resources are shared and accounted for amongst them. This has, understandably, lead to consideration of an outsourced service arrangement and identification of some of the activities that would be necessary in order to put this arrangement into effect. For example, the allocation of resources to ELEXON/BSCCo, the composition of the BSCCo Board and so on.

A dependency has thus been established (unnecessarily in our view) between the implementation of alternative ownership and governance arrangements and the establishment of a services contract i.e. the suggestion that revised governance and ownership arrangements cannot be implemented without establishing a services contract at the same time. It is our view that there is no dependency between these activities, and these considerations should be de-coupled and considered/implemented quite independently of each other.

As part of their Code Governance Review[1] Ofgem stated their preference ("2.32. We also consider that there is merit in the concept of introducing service contract structures for codes such as CUSC, BSC and UNC. We consider that such structures have the potential to promote competition in the provision of code administration services") for a services type contract covering the BSC arrangements. We recognise this may be industry's preferred operating model and readily acknowledge that it may be appropriate to move to an alternative arrangement at some time in the future. However, we do not see this as a pre-requisite to unlocking our

[1] Code Governance Review – role of code administrators and small participant/consumer initiatives – initial proposals. http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Documents1/Code%20Governance%20Review%20–%20role%20of%20code%20administrators%20and%20small%20participant-consumer%20initiatives%20–%20initial%20proposals.pdf

governance and vires. A contract model could we believe, be implemented now under the existing governance arrangements if BSC Parties were so minded, just as it could have been implemented at any time in the past.

The proposed governance and ownership arrangements that ELEXON has promoted seek to minimise the scope and complexity of change that's necessary by leaving the current BSC arrangements largely unchanged so that alternative arrangements can be implemented quickly. This approach would enable ELEXON to play a full and active part in the DCC Licence application process and other Government schemes.

Cost Benefits Analysis

The financial and operational benefits from the implementation of a services contract have not been described or quantified in the Report.

Regarding costs, the Report acknowledges that costs will, at least in the short term, increase through the addition of the profit margin that ELEXON will earn on the BSC service contract and through the establishment and ongoing resourcing of the organisation that will have to manage and oversee the services contract. More significantly however, we believe that the implementation and transitional costs will be significant, due to the time it will take and the internal and external resources required to negotiate the BSC into the type of contract that's contemplated in the Report. In the ELEXON proposal, there is no requirement to turn the Balancing and Settlement Code into a services contract. If a procurement is required of the initial services contract then these costs will be higher still.

As regards benefits, reference is made to an anticipated cost reduction arising from subsequent competitive re-procurement e.g. in 10-15 years time. However, approximately half of ELEXON's costs are already the subject of competitive tendering (Logica, PWC etc) and much of the remainder are non-controllable (office lease). Furthermore, we are not aware that any existing service contract arrangements with Gemserv/MRASCo, which is the comparator used in the Report, have been subject to re-procurement. It is therefore highly questionable in our view whether the perceived benefits of a services contract will be realised. In contrast, we would highlight the cost reductions that have been achieved over the life of the NETA arrangements; since 2001, annual operating costs have been reduced from £70m to £33m, all without the existence of a services contract. In addition, we described in our 2011-12 Business Plan, likely savings to BSC Parties of £1m per annum arising from a contribution to existing central overheads from new business.

Transparency

The introduction of a services contract will reduce the transparency of our costs and services and instead, BSC Parties will have to rely on the BSCCo Board enforcing the terms of the services contract. This makes BSC Parties one step further removed from the service provider.

Currently ELEXON provides more information on its budget and services than any other central body. This will inevitably reduce if the provision of those services moves to a "more commercial" contract arrangement.

We are of the view that adequate mechanisms already exist within the existing governance framework to incentivise ELEXON's Executive team to drive down costs through efficiency improvements particularly as the Chairman of the BSC Panel and the ELEXON Board is appointed by Ofgem.

Report observations

Para 61 and 62: Para 61 highlights a number of issues that will need to be resolved including "The terms of the new contract", resourcing of BSCCo. Para 62 of the Report suggests these issues will have to be resolved anyway under ELEXON's proposals. We do not share this view and as highlighted earlier, creating a dependency between alternative governance arrangements and the implementation of services contract introduces unnecessary complexity and creates implementation delays.

Para 67: For clarity, the ELEXON Board is not formally constituted of "ELEXON Members…". The Chairman of the Board is the only ELEXON person (note the Chairman is appointed by Ofgem) that is a formal Board Member. Others, e.g. ELEXON's Chief Executive, attend the Board at the invitation of the Chairman but is not a Board Member.

d) Funding

The immediate challenge for ELEXON is how growth is to be funded. Going forward, we have never proposed that BSC Parties be obliged to provide funding. Instead we have stated that funding will be sourced from third parties and/or willing BSC Parties. This will be on a commercial basis. We recognise that the establishment of an enduring services contract containing a profit margin would provide an immediate source of funding against which further funding could be raised and as stated earlier, we acknowledge that at some point in the future it may be appropriate to move to such an arrangement.

However, our immediate concern and priority is to establish some form of transitional funding arrangement such that ELEXON is not prevented from participating in and competing for smart and other government programmes such as EMR in line with our objective to reduce costs and complexity for the industry and consumers. We will continue to develop our thinking in this area and will come forward with proposals shortly.

As an example, we have previously proposed that if successful in securing the DCC role, we would repay to BSC Parties any initial smart funding loan. This approach could we believe be codified in the BSC to give BSC Parties the appropriate protections and in particular, a loan "cap" which could, as an example, be tied to the BSCCo Annual Budget.

In addition, we acknowledge that industry, Government and the regulator will want assurance that regulated subsidiaries are protected e.g. BSCCo or other services awarded under licence e.g. the DCCo. It is anticipated that the relevant industry codes will contain appropriate restrictions on the regulated subsidiaries. Examples of current restrictions in the BSC include:

- granting security over ELEXON property;
- entering into borrowing; and
- making loans to any person.

Report observations

Para 29 – Financial Returns: The report rightly questions the interest from BSC counterparties to facilitate ELEXON's diversification unless there is some form of return to BSC members in the form of lower costs and/or improved quality of service. The report further states that ELEXON has not provided any concrete evidence of the benefits that would accrue.

This is a similar question to that asked by BSC Parties and others in 2011/2012 BSCCo Business Plan consultation responses and also discussed with the BSC Panel. As set out in the final version of the BSCCo Business Plan (http://www.elexon.co.uk/ELEXON%20Documents/elexon_business_plan_2011-12_for_consultation.pdf) we estimate that if ELEXON was undertaking new smart metering roles alongside the existing BSC role, BSC Parties will benefit from a reduction in BSCCo costs arising from recharging a proportion of BSC fixed costs to the new entity. This will potentially exceed £1m per year and would therefore represent a saving in excess of £10m for BSC Parties over, for example, the first 10 years of DCC operations.

We believe that these potential savings present a compelling business case for BSC Party funding ELEXON's proposed smart metering activities.

Para 29 casts doubt on the not for distribution model, by stating that those providing capital will call this element (i.e. the not for distribution element) into question. We disagree. Where capital is provided into subsidiaries in the form of joint ventures, those providing capital will extract their return in the form of distributions; it is the distribution to ELEXON Holdco that will remain within the group and not be distributed to Holdco members.

Para 23 – Developing a diversified business: The Report incorrectly identifies the 2011/12 Business Plan provision of £1m as relating to business diversification. This provision relates to a one-off organisational development provision in 2011/12 and not business diversification or expansion.

e) Implementation

Ofgem's open letter of 29 July 2011 acknowledges ELEXON's aspiration to participate in the competition to be the DCC, as set out in ELEXON's Business Plan 2011-12. Ofgem also recognised ELEXON's extensive experience of settlement and the procurement and management of contracts to fulfil our expert role. Ofgem states that:

- ELEXON possesses extensive experience of settlement and the procurement and management of contracts to fulfil its expert role;
- important synergies may exist between the data settlement processes currently run by ELEXON and the anticipated role of the DCC;
- consumers may benefit from our participation in the competition to undertake the DCC role; and
- ELEXON will have an important role in helping industry meet the challenges to market operations presented by policy aims including the move to a low carbon economy.

ELEXON's key objective is to support industry's smart programme and to play our part in ensuring that the DCC Licence application process includes an appropriate level of competition and that government and ultimately consumers do not pay more than is necessary for want of a fully competitive process. Similarly we wish to provide central services as part of Electricity Market Reform and avoid the unnecessary duplication of systems and costs.

We are deeply concerned that if the implementation approach outlined in the Report were adopted, in particular the negotiation of a full services contract ELEXON will not achieve a relaxation of its vires in time to participate in the DCC Licence application process or present a credible bid within the published timescale of Q2 2012. We believe it is for DECC to determine which organisation is to provide new central services and not to have that choice denied it by procrastination or diversion due to the (unconnected) introduction and negotiation of a services contract. Furthermore, in the interim, ELEXON's competitive position, in particular the ability to enter into joint venture or consortium agreements, continues to be undermined given the vires uncertainty.

This situation clearly underlines the need for urgent action and proactive leadership from DECC and Ofgem to push forward the reform of ELEXON's current business structure in order that ELEXON might play a fuller role in delivering these critical market reforms.

Alternative transitional arrangements must therefore be found, and we believe these should, at least initially, include the uncoupling of the governance reform proposals from the implementation of a full services contract, with vires being unlocked first to enable us to participate in key Government initiatives, followed by the introduction of a full contract (assuming Ofgem conclude a services contract is desirable). It is our view that unlocking our vires could be implemented within 3 to 6 months. We would therefore encourage Ofgem to publish, either as part of their consultation on ELEXON's governance and vires or, in their conclusions document, a firm implementation plan for unlocking our vires and, if desired by Ofgem, of subsequently finalising a service contract.

Report observations

Para 81 to onwards – Implementation: We welcome the Report's acknowledgment that time is of the essence if ELEXON is to participate fully in DCC opportunities. However, we question whether "the significant amount of negotiation" (para 85) is absolutely necessary, particularly if the implementation of the governance reforms and the implementation of a services contract, are uncoupled.

Para 100 onwards – Next steps: para 101 of the Report rightly identifies the need for ELEXON and BSC representatives to agree a framework for adopting a structure. We have significant concerns that existing BSC "collective bargaining" arrangements are not suitable to address these governance reforms and that whilst all parties need to be actively engaged in moving the reform proposal forward, Ofgem and DECC will need to take a strong and directive leadership role if the reform proposals are to stand any chance of being implemented such that ELEXON is enabled to fully and meaningfully participate in the DCC Licence application process and other Government policy initiatives and reforms e.g. Electricity Market Reform.

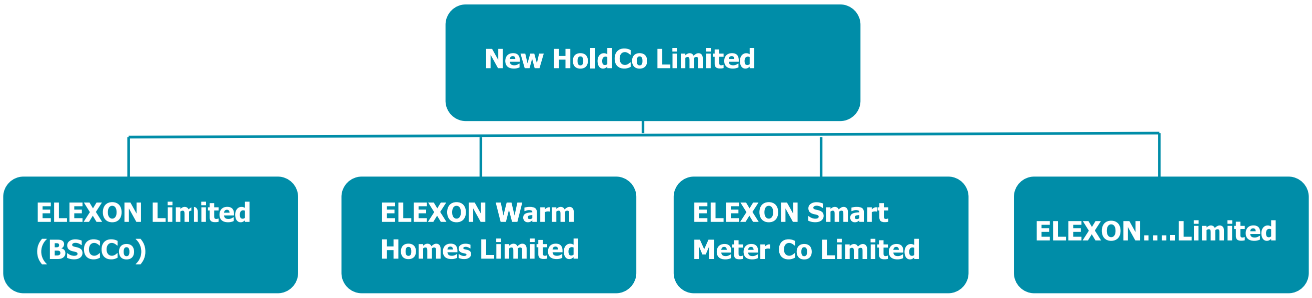
Para 84: We disagree that clarity over governance structure by mid 2012 will suffice. The Report refers to mid 2012 because, we assume, the SMIP programme has indicated DCC licence award process will commence Q2 2012. This may mean the process commences in April and in any event in order to attract partners and/or funding, ELEXON must have demonstrable certainty that our governance will be unlocked at least 4-6 months in advance of the commencement of the DCC Licence application process.

Appendix 1 - Detailed description of ELEXON's proposed new ownership and governance model

Structure, purpose and governance of new HoldCo

This section identifies the proposed new corporate structure for the ELEXON Group of companies, describes the group's purpose and the nature of the new holding company, and sets out its governance, in particular the make-up of its members, and the constitution of its board.

The following new corporate structure is proposed:



A new umbrella holding company (New HoldCo) will be established to be the parent of the ELEXON Group. The ELEXON Group subsidiaries are initially likely to include ELEXON, ELEXON Warm Homes Limited and a wider corporate group engaged in other commercial ventures including (if bid and selected) the Data Comms Company (DCC), Smart Energy Code Company (SEC Co) as well as EMR roles.

This suggested corporate structure is typical of many organisations and ensures that, in the absence of express support, the risks of one business are kept separate from another. Each company has limited liability.

The ELEXON Group subsidiaries will be a combination of:

- regulated not for distribution entities e.g. BSCCo;
- for distribution entities earning regulated returns e.g. (if bid and selected) the DCC and SECCo; and
- for distribution entities e.g. Warm Homes Limited (plus joint ventures and limited liability partnerships).

The separate entities allow this distinction of for distribution and not for distribution to be maintained within an overall corporate group. In addition each subsidiary will be subject to its own tailored governance arrangements.

Purpose of New HoldCo

The principal purpose of New HoldCo will be:

- the promotion, development and implementation of innovation, cost efficiency, improvements and rationalisation through the provision of regulated and unregulated services to the utilities sector for the benefit of industry, consumers, regulatory bodies and other legal authorities.

This will provide members and the wider community with the assurance and transparency that the activities of the ELEXON Group are appropriately focused but also provide flexibility for the ELEXON Group to pursue commercial ventures across the wider energy sector.

What type of company will New HoldCo be?

New HoldCo will be established as an independent "not-for distribution" company meaning that any profit accruing to New HoldCo will not be distributed to members but instead profits can be:

- re-invested within the ELEXON Group for business growth;
- retained for future investment; or
- used to offset the cost of service provision.

New HoldCo will be a company limited by guarantee (**CLG**). As a CLG, members are not shareholders of New HoldCo and do not contribute capital in the form of equity. Instead they act as guarantors who are required to provide a guarantee which can be called upon, in the event of the winding up of New HoldCo. The guarantee is usually a nominal sum, typically £1.00. It is proposed that all members of New HoldCo will have an equal guaranteed liability. A CLG benefits from corporate status which includes limited liability for its members, the liability being limited to the amount of the guarantee.

A not for distribution CLG structure has been selected as it gives comfort to stakeholders that the ELEXON Group is primarily concerned with providing value and service to its members (who are often its customers) rather than returning dividends to its shareholders. CLG's are commonly found in charities, the arts, education, healthcare and trade bodies. Examples of other organisations where the holding company is a CLG include the Carbon Trust, Network Rail and certain water authorities.

Other forms of company structure, for example, a company limited by shares or a trust, have been considered but discounted:

- a company limited by shares status can be more problematic for a company where its profits are not to be distributed to its members/shareholders;
- a trust attracts personal and unlimited liability for the trustees which is not considered to be appropriate in this case.

In the absence of a distribution of profits to members, and given that members are not required to provide capital in the form of equity into the ELEXON Group (merely to provide a guarantee to contribute an equal nominal amount in the event of a winding up) the risk that one member (or a class of members) may seek to unduly influence the Group for its own financial benefit is mitigated. Similarly, as membership is non-transferable and with an appropriate limit on voting rights (see below) one member or corporate group cannot accumulate a significant interest.

Corporate governance of New HoldCo

Given that New HoldCo will not be a listed company it will not be formally required to comply with the requirements of the UK Corporate Governance Code (the **Code**). Nonetheless, New HoldCo intends to adopt best practice, to report on corporate governance issues and to comply with the principles and recommended best practice of the Code to the extent it is relevant.

Ownership of New HoldCo

As with any company it is necessary to determine who the members (owners) will be. The following membership principles have been established:

- membership should be constituted from the stakeholders that New HoldCo will benefit; this should include stakeholders for current BSC activities and stakeholders in potentially new ELEXON Group activities;
- membership requirements must be sufficiently flexible to allow for other additional parties to become members to reflect any further changes in ELEXON Group activities that have yet to be anticipated;
- the membership arrangements must not be capable of manipulation such that any one member is able to exert undue influence to the detriment of other members, for example it is proposed that whilst different entities within a corporate group may be entitled to become members of New HoldCo, such corporate group will only be entitled to one vote (on behalf of that corporate group) in any members' resolution;
- the community of members should provide appropriately skilled and qualified people from which non executive directors may be nominated.

The approach that is therefore proposed is to invite the following to be members of New HoldCo:

- all holders of current licences issued under relevant electricity and gas legislation;
- all signatories to all gas and electricity industry codes; and
- relevant consumer representative organisations.

A member may resign on giving notice (and may be removed if they cease to satisfy the above criteria or become insolvent etc).

There is no minimum or maximum number of members and membership is non transferable.

This approach to membership will ensure that the widest possible community of stakeholders can become members of New HoldCo and hold it to account for its actions and services and can participate in the decisions made by New HoldCo via: (i) members' resolutions; and (ii) the nominations process for directors (see below).

Influence of Members and other Stakeholders

New HoldCo's Board will regularly consult with its members and other stakeholders. Through a series of group and one to one stakeholder meetings, their views will be taken into account in the Board's business planning process. The New HoldCo Board will encourage input from its members and other stakeholders on an ongoing basis. In particular, New HoldCo will keep the Members informed of the ELEXON Group activities, progress and performance via performance statements, annual reports and financial statements.

An AGM will be held each year which will include presentations on general and financial performance and other Members' meetings will occur from time to time as may be necessary or desirable. At Members' meetings, members will be entitled to vote on members' resolutions.

The first Chairman of New Hold Co will chair members' meetings and Board meetings for an initial 3 year period although he may be re-elected by the Board.

In addition to members' meetings, members will also be able to influence New HoldCo through directors proposed by members who represent members' interests at the Board. This is described in more detail below.

Constitution of the Board

The purpose of the New HoldCo Board will be:

- to provide leadership within an effective framework of controls;
- to set the strategic aims of the ELEXON Group;
- to ensure the availability of necessary financial and human resources;
- to review performance of management teams and of the group; and
- where profits arise, to allocate these within the group in a manner consistent with the ELEXON Group objectives.

Decisions of the Board will be by majority and each director (in the absence of any conflict) will be given notice of Board meetings and will be entitled to attend and vote. The New HoldCo Board will comprise executive directors and non executive directors. Non executive directors will include representatives of the members and of other stakeholders and interest groups. This is to ensure that members' interests are represented at the Board as well as other stakeholders. It also provides the opportunity for the Board to include individuals with specific desired experience which can be of benefit to the ELEXON Group.

Executive Directors

The Board shall include the following executive directors:

- Chief Executive;
- such other employees or officers as appointed by the Board having been nominated by the Nominations Committee.

Non Executive Directors

The Board shall include the following non-executive directors:

- Chairman; and
- such other persons recommended by the New HoldCo Board and duly approved by the Members

Only individuals recommended by the Board are eligible for election as non-executive directors. The Board can only recommend individuals who have been nominated by the Nominations Committee. The Nominations Committee, chaired by the Chairman, will nominate individuals in accordance with appropriate Eligibility Criteria which will be set out in the committee's terms of reference. It is proposed that these criteria will include:

(1) provisions enabling members to propose individuals to the Nomination Committee from time to time; and

(2) a requirement that the Nominations Committee have regard to the appropriate representation of consumers' interests when nominating individuals to the Board.

Directors may be appointed to the board at any time however, all appointments will be subject to ratification at the next Annual General Meeting (**AGM**) of New HoldCo.

All director appointments will be made in accordance with the process and practices prescribed in the Code.

Distribution of profits

The use of retained profits by New HoldCo will be at the discretion of the New HoldCo Board.

The ELEXON Group will include some companies that are not for profit e.g. BSCCo, other entities that are allowed to make regulated returns e.g. (if selected) the SEC/DCC, and entities that are fully for-profit. Only profits from the entities that are permitted to make returns may be remitted to New HoldCo. Surplus BSC funds will be returned to BSC Parties as provided in the BSC and New HoldCo will have no powers to alter this arrangement.

Restrictions on activities

It is anticipated that some ELEXON Group subsidiaries will carry out regulated activities (**Regulated Subsidiaries**). The introduction of New HoldCo and the new corporate structure is not intended to affect or circumvent such arrangements. Subsidiaries such as BSCCo will continue to fully perform its obligations and functions in accordance with the BSC arrangements (including the restrictions imposed on BSSCo). This will similarly apply to funding arrangements and the return of any surplus funds which are currently required to be returned to parties to the BSC.

In addition, we acknowledge that industry, Government and the regulator will want assurance that regulated subsidiaries are protected e.g. BSCCo or other services awarded under licence e.g. the DCCo. It is anticipated that the relevant industry codes will contain appropriate restrictions on the regulated subsidiaries. Examples of current restrictions in the BSC include:

- granting security over ELEXON property (except in certain circumstances);
- entering into borrowing (outside prescribed limits); and
- making loans to any person (except in certain circumstances).