

**Stage 01:** Recommendation to raise a Modification Proposal

What stage is this document in the process?

01 Initial Written Assessment

02 Definition Procedure

03 Assessment Procedure

04 Report Phase

Enabling ELEXON to participate in tendering for DCC Licence and/or the Smart Energy Code administrator roles via a subsidiary

A recommendation from the BSCCo Board that the BSC Panel raise a Modification.

The Panel are asked to consider raising a Modification that would amend the BSC to allow ELEXON to establish a subsidiary which can participate in the Data Communications Company (DCC) and/or Smart Energy Code (SEC) administrator bid process and, if successful, act as DCC and/or SEC administrator.

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About this document:

This is a recommendation from the BSCCo Board to the Panel to raise a Modification Proposal.

We will present this recommendation to the Panel on 13 December 2012. If the Panel agrees to raise the Modification Proposal, this document will also form the Initial Written Assessment and sets out how we believe the change should be progressed.

The Panel will be asked whether they wish to raise the Modification Proposal and, if so, how to progress it.

You can find further information in the attached Modification Proposal (Attachment A) and draft BSC legal text (Attachment B).



Any questions?

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1 Why Change?

Background

ELEXON administers the Balancing and Settlement Code (BSC) by fulfilling the role of BSC administrator on a not for profit basis. Although ELEXON is a wholly owned subsidiary of NGET, NGET does not have a place on ELEXON's Board and has no financial or other obligations or management control over ELEXON. ELEXON's costs are borne by industry and it has successfully reduced its overall running costs year on year¹. A restriction in the BSC prevents ELEXON from providing services to government or industry beyond the BSC.

In 2010 ELEXON first communicated its belief that its expertise and experience should be applied more widely for the benefit of industry, government and, ultimately, the consumer as part of its 2011/12 Business Plan.

As a result of responses received to the Business Strategy consultation in February 2011, and an Industry workshop in March, Issue 40 "Review of ELEXON Governance and Funding Arrangements for New Business Opportunities" was raised by E.ON in March 2011. Issue 40 considered options for an appropriate governance framework to allow BSCCo to pursue business development opportunities which it was precluded from under the Code. The Issue 40 group was tasked with considering and developing a number of viable governance proposals which could form the basis for one or more future Modifications.

The Issue 40 group also considered:

- The extent to which ELEXON should be permitted to pursue new business development opportunities;
- The process for setting budgets, authorising expenditure and ensuring effective accountability to BSC Parties;
- Funding arrangements and the extent to which costs and risks should be allocated to BSC Parties that benefit from new business developments;
- How surplus income generated from new business development opportunities are used including (a) consideration of repayments to parties required to/choosing to fund such activities and/or (b) reductions to BSCCo Charges;
- The separate accounting and ring fencing of new business activities from existing BSC activities, and whether new organisation or ownership structures are required;
- The respective roles of the Board and BSC Panel, the Transmission Company and Trading Parties (for the above); and
- An appropriate regulatory regime.

The Issue 40 Group discussed three potential models, which in summary are:

- **Model A** - the creation of a new umbrella holding company to be the parent of an ELEXON Group. BSCCo would become a wholly owned subsidiary of this new holding company (rather than National Grid), but is otherwise unchanged in structure, funding, role or governance and remains cost pass through/non-profit making. New business ventures would be competed for and delivered as ring-fenced subsidiaries of the new holding company.
- **Model B** - the creation of a new company to procure and manage a BSC services company which would provide all the services that BSCCo does today, but under a

¹ In real terms, ELEXON's running costs have fallen year on year from £106.5 million in 2001/02 to £33.9 million (latest forecasted budget) for 2012/13.

contestable commercial services contract. The ownership, governance, funding and profit status of ELEXON Limited would be changed. The BSC ServeCo contract would include a profit margin and appropriate incentives to reduce charges.

- **Model C** - the existing governance and funding of BSCCo as a wholly owned subsidiary of National Grid remains. All future roles would be undertaken by ELEXON under this structure via incremental modification of the BSC.

The Issue 40 Group concluded that Option C should not be progressed. However, options A and B could potentially be used to enable ELEXON to undertake a wider set of business activities. The Group preferred Model B.

Parallel and separate to Issue 40, Ofgem commissioned an independent advisor (Richard Morse) to deliver a report on any issues that might arise from ELEXON diversification and how such issues could be addressed. The Morse Report was published on 29 July 2011, six weeks before the Issue 40 report was published (in September 2011).

Following the Morse Report, Ofgem issued a consultation in November 2011 on the potential expansion of ELEXON's scope and vires to allow it to take on additional work beyond that set out in the BSC. Ofgem acknowledged that the main driver for ELEXON's diversification was the role of the DCC and considered that "there may be some synergies between the processes currently run by ELEXON and the anticipated role of the DCC, as well as the potential for cost savings from the more efficient use of its fixed assets and other resources. Consumers may therefore benefit from Elexon's participation in the competition to undertake the DCC role."

The November consultation set out four expansion conditions that would need to be satisfied before any expansion could occur, with the aim of protecting BSC Parties and ultimately consumers. These expansion criteria were:

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

The consultation also identified two possible restructuring models (the "contract model" and the "subsidiary model") that could satisfy the expansion conditions. Ofgem's preliminary view was that while either of the two models would be viable, the 'contract model' would most effectively meet the expansion conditions.

On 30 April 2012 Ofgem concluded that ELEXON should be allowed to do more if the expansion criteria are satisfied, and reaffirmed their view that a contract model appeared most likely to effectively mitigate the size and nature of risks associated with ELEXON undertaking an activity such as the DCC.

As part of their conclusions Ofgem also acknowledged the concerns raised by several consultation respondents that a contract model may be more expensive to implement and therefore suggested that there may be more proportionate means of allowing a limited expansion of ELEXON's activities without requiring its separation from the BSCCo in the form of the BSC Board.

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As a result of the Ofgem conclusions letter National Grid raised Modification P284 "Expansion of Elexon's role via the 'contract model'" in May 2012. P284 sought to amend the BSC to enable the BSCCo Board to outsource its activities to a new entity ('New ELEXON') under a for-profit contract, if it chose to do so. P284 was approved by Ofgem in September 2012.

On 27 November, ELEXON's Board concluded that, whilst ELEXON diversification will undoubtedly bring longer term benefits to consumers, the industry, Government and to staff, the proposed contract model could not meet one of Ofgem's four expansion conditions and therefore the contract model could not be pursued at this time.

The condition that the Board could not resolve was 'BSC Parties should benefit from diversification'. This proved impossible when considering a shift from a not for profit to a for profit service which, would be coupled with increased overheads arising from the need for two companies (customer and provider) where there had been only one in the past. The arising costs could not be outweighed by profit share and overhead reduction arising from new work, that by its nature could not at this time be quantified or guaranteed.

The Board recognising the benefits of diversification and the specific Opportunity of the DCC Licence Award requested that ELEXON explore how to enable participation in the Licence Award. How to resolve matters was discussed at a subsequent meeting of the Board on 5 December.

Following its meeting on 5 December a paper was circulated to the Board asking that they:

- RECOMMEND to the BSC Panel that a BSC Modification is raised, on the grounds of efficiency, to enable ELEXON to bid for the DCC; and
- RECOMMEND to the BSC Panel that in light of the pressing timescales, the Modification is progressed as Urgent.

On the grounds that a modification was limited solely to the DCC and SEC roles, and did not compromise delivery of the BSC services, the recommendations were supported by 3 of the 4 non-executive directors and hence this request from the BSCCo Board that the BSC Panel raise a Modification and treat it as urgent. A copy of the Board paper and statements from each of the Board members will be tabled at the Panel meeting.

The Data and Communications Company (DCC)

As part of the new smart metering arrangements a new licenced body, the DCC, will be established to manage the delivery of the central arrangements.

The Data and Communications Company ("DCC") is a key element of the Government's approach to rolling out smart meters in Great Britain. The principal role of the DCC will be to procure, manage and assure communication services with smart meters at all domestic gas and electricity consumer premises. Recognising the strong parallels with services that ELEXON currently provides under the BSC, the opportunity is strongly aligned to ELEXON's vision.

The DCC will be appointed through a competitive process which has already started. ELEXON (as a separate non BSCCo entity) has qualified from the first stage of the four stage Licence Award Process and is well placed to continue. In order to progress its

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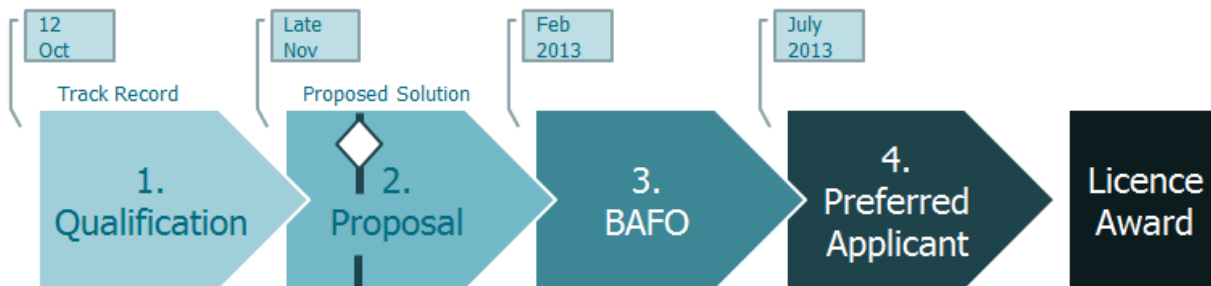
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application ELEXON needs to be able to deploy its resources (principally undertaking work at risk) and have a clear corporate structure for its submission. A means of addressing this is put forward in this Modification. Recognising that the award process is active places time pressure on resolving this issue and hence the request for Urgency. The key steps in the Licence Award process and their timings are illustrated below:



The DCC role has been under discussion for several years. With the emergence of the DCC Licence and the Version 1 of the Smart Energy Code there is now clarity around the role the attendant risks and rewards. ELEXON have progressed a delivery model and has successfully demonstrated its track record of delivery in qualifying the first stage of the award process.

In recommending this Modification the Board sought confirmation that the risks around the DCC have been clarified and significantly contained since the role was initially proposed. For example, it is not responsible for the defaults of its service providers, and liabilities that it does have to assume are commensurate with the risks and rewards, and when necessarily higher can be socialised amongst its users.

The Board also sought confirmation that the DCC will receive revenue from Licence award and so is not required to fund months of mobilisation prior to invoicing its users (invoicing a month in arrears there would be a short period from the Licence Award date, that the DCC would need to cover its own operating costs prior to the first invoicing but these costs would be covered by a bank loan to the DCC).

The Board also discussed the how a failure of the DCC infrastructure would adversely impact settlement through disrupting the flow of metered data and possible misallocation of energy resulting in severely compromised data quality. Conscious of the disruption that occur in supply competition in 1994, the Board recognised that ELEXON through its BSCCo role has an overwhelming imperative to ensure that the DCC arrangements function efficiently and effectively. The Board also recognised that ELEXON have a natural incentive to drive the roll-out since ELEXON and hence BSC Parties will bear the inefficiency of operating duplicated legacy and smart arrangements. If this were to occur it could also constrain the smarter markets initiative and the development of smart grids.

ELEXON and the Board believe that participation in the DCC bid would be beneficial to the industry. As a participant with a clear proposition, ELEXON enhances the competitive process and thereby contributes to developing the best solution and lower costs regardless of who wins. If successful, shared assets, overheads, processes and services will lower the costs of the BSC arrangements. ELEXON recognises that participating means committing BSC assets (and hence costs) but believe this will be outweighed by the benefits of enhanced competition.

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What's the Issue?

ELEXON cannot participate in the DCC Award process due to the current BSC drafting.

The key constraints currently imposed on ELEXON Ltd by the BSC include provisions which preclude ELEXON or its subsidiaries undertaking work outside the BSC, and which therefore prevent:

- ELEXON or its subsidiaries from providing DCC/SEC services outside its core BSC activities; and
- ELEXON or its subsidiaries holding interests in appropriate legal entities to deliver DCC/SEC services outside the BSC

To resolve this issue the BSCCo Board are requesting that the Panel consider raising the attached proposed Modification.

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Solution

The proposed solution is to allow a limited expansion of ELEXON to undertake only the DCC bid/role (and potentially the SEC administrator in addition to or instead of the DCC role). This would be done via a separate subsidiary (called 'Smart Co' in this Modification) of which BSCCo would be the parent company.

The solution is designed to ring fence BSCCo from any costs and risk associated with running the DCC/SEC administrator. BSC Parties would fund the DCC bid, but that funding has been capped at £300K. Because the funds would be drawn from the underspend in the 2012/2013 Annual Budget, Parties would not be asked to make any additional payments, and if successful the funds would be recouped from the operation of the DCC and repaid to Parties.

The Modification requires that Smart Co profits would defray costs incurred by BSC Parties and any dividend given by Smart Co to BSCCo, as a result of the DCC work, would be distributed amongst Parties based on BSC funding share.

The Key features of this proposal are outlined below:

Establishing a 'Smart Co' subsidiary

- ELEXON will be able to pursue opportunities for the award of the DCC/SEC via a subsidiary company, referred to as "Smart Co". throughout this Modification when referring to such company);
- Smart Co will be:
 - wholly owned by BSCCo for the benefit of BSC Parties; and
 - a separate legal entity, thus all costs and liabilities incurred by Smart Co will be kept separate from ELEXON's core BSC services;
- If Smart Co is awarded any of the Smart Energy Activities, 100% of dividends declared by Smart Co will be distributed to BSCCo (for the benefit of BSC Parties in accordance with their funding shares, thereby representing a cost saving to BSC Parties). The declaration of dividends by Smart Co will be subject to the approval of the BSCCo Board;
- BSCCo will have no financial liability or obligation to Smart Co, subject to the provision of Smart Funding (see below);
- BSCCo may not place Smart Co in breach of its legal requirements (e.g. DCC licence obligations);
- The current chairman of BSCCo will be the initial chairman of Smart Co and will in consultation with the Panel set out a process to appoint other initial directors. Smart Co will comply in all material respects with the UK Corporate Governance Code (subject always to the preceding point that BSCCo may not place Smart Co in breach of its legal requirements); and
- ELEXON is prohibited from disposing of Smart Co (Section C, paragraph 3.4.5(c)).

Funding of Smart Energy Activity bids

- Subject to the following conditions, ELEXON may provide funding for the award of the Smart Energy Activities in the form of a loan/credit to Smart Co in order to enable it to meet its costs, expenses and other outgoings in connection with the planning, preparation and negotiation of a Licence/contract ("Smart Funding"). These

conditions are:

- (i) Third party costs incurred in connection with Smart Energy Activities (e.g professional advisor costs) will be limited to £300,000;²
- (ii) Smart Co's overheads (e.g personnel costs) will be initially met by BSCCo but subject to a statement of account at the conclusion of the bid activities.
- (iii) Smart Funding must be at arm's length and on normal commercial terms.³
- (iv) Smart Funding will be subject to ELEXON's statutory audit;
- (v) If Smart Co is awarded one or more Smart Energy Activities, Smart Co will repay aggregate Smart Funding in respect of that successful bid to ELEXON within a defined period.⁴ For the purposes of repayment, Aggregate Smart Funding will comprise:
 - (a) Smart Co's third party costs plus interest at the agreed rate; and
 - (b) Smart Co's overhead costs repayable on a capital repayment basis.

BSC Parties will, in turn, be reimbursed in accordance with their respective Funding Shares;

- (vi) If Smart Co is unsuccessful in tendering for one or more Smart Energy Activities ELEXON will write off the Smart Funding in respect of that unsuccessful bid (on the basis that Smart Co will have no assets);
- (vii) All unused funding will be returned by Smart Co to ELEXON;
- (viii) ELEXON will be under an explicit BSC obligation to procure that Smart Co provides reports to ELEXON at regular intervals on Smart Funding (excluding confidential and/or commercially sensitive information).

Prohibition of cross - subsidies

- ELEXON will be under an explicit BSC obligation not to give or receive any cross-subsidy from any affiliate⁵;
- If Smart Co is awarded any of the Smart Energy Activities ELEXON will be under an explicit BSC obligation to develop procedures to ensure that any common or shared costs are allocated fairly and reasonably between ELEXON and Smart Co (i.e. Smart Co will not pay less than market rate).
- Intra group company transactions will be subject to ELEXON's statutory audit.

Continuity of BSC services

To ensure there is no degradation in ELEXON's BSC services, ELEXON will be under an explicit BSC obligation to ensure that at all times it has sufficient resources (including personnel) to fully discharge its BSC responsibilities

² There is sufficient underspend in the 2012/2013 Annual Budget to cover Smart Funding.

³ This provision reflects, in part, Standard Condition B9 of NGET's transmission licence.

⁴ It is suggested that this period should be a maximum of 12 years to reflect the duration of the initial DCC licence period.

⁵ This provision reflects Standard Condition B5 of NGET's transmission licence.

Ofgem's Four Expansion Criteria

The BSCCo Board believe that this Modification would meet Ofgem's four criteria, for the reasons set out below.

| Ofgem condition | Satisfied by: |
|---|---|
| (a) BSC Parties should benefit from any diversification. | <ul style="list-style-type: none">• Cost reductions through the sharing of fixed overheads;• Participation in new business profits;• Creation of a new competitor/consolidator amongst the small field of central market arrangement delivery agents;• Mitigate risks of an adverse impact of settlement arising from a DCC failure. |
| (b) The arrangements should not place disproportionate risk on BSC Parties. | <ul style="list-style-type: none">• Separate legal entities for non-BSC activities;• No pledging or transfer of assets;• No guarantees. |
| (c) Standards of Service under the BSC should be maintained. | <ul style="list-style-type: none">• No change to existing service standards;• New obligation to ensure BSC is always properly resourced. |
| (d) ELEXON's BSC role should not give it any undue competitive advantage in a contestable activity. | <ul style="list-style-type: none">• Within-group services to be at arms-length;• Ofgem acknowledged this test was met if tests (a) and (b) were met. |

Can the Panel Raise this Modification?

The BSCCo Board have requested that the Panel raise this Modification, but its ability to do so may be questioned. This section sets out the provisions relevant for the consideration of this question and the reasons why the Board believe the Panel may raise the Modification

Section F 2.1.1 (d) (i) states that the Panel may raise a Modification "*on the recommendation of BSCCo in accordance with Section C3.8.8*".

Section C3.8.8 states that "*...BSCCo shall keep under review whether any possible modification of the Code from time to time would better facilitate the objective in Condition C3(3)(d) of the Transmission Licence, and shall recommend to the Panel any particular such modification which in BSCCo's opinion would do so.*".

The Transmission Licence Condition C3(3)(d) references Applicable Objective (d), which is "*promoting efficiency in the implementation and administration of the balancing and settlement arrangements.*"

In short, BSCCo may request the Panel raise a Modification where BSCCo believe that it better facilitates Applicable Objective (d).

Arguments against Applicable Objective (d)

BSCCo has put forward the following two arguments to support its belief that the Modification would better facilitate Applicable Objective (d).

- BSCCo believes that its participation in the DCC bid process will result in a better more robust DCC due to both the competitive pressure its participation in the bid would add to the process (irrespective of if it is awarded the DCC role) and the benefit its expertise would have if it was awarded the DCC role. This assertion is based on the knowledge and experience that BSCCo has in running similar processes to the DCC, and recognises Ofgem's conclusions that "Consumers may therefore benefit from ELEXON's participation in the competition to undertake the DCC role". It is argued that since the DCC will become a vital source of data across the industry

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it is extremely important that the DCC be as of the highest quality and robust as possible. If the DCC is not of the highest quality possible, which can only be ensured by considering all of the potential avenues of delivering the DCC, then there is a potential that data quality across the market will fall which would have a significant impact on settlement and the BSC arrangements in general. BSCCo clearly have a unique interest in ensuring that Settlement data be maintained to the highest standard and that Settlement be safeguarded. Therefore this Modification would promote efficiency in the implementation and administration of the Settlement arrangements by ensuring that the DCC is of the best quality and Settlement protected.

- If BSCCo were to win the DCC bid and become the DCC provider, BSC Parties' costs would be defrayed. In addition any dividends provided to BSCCo from the DCC work would be returned to Parties, reducing the costs of running the BSC and ultimately increasing the efficiency in the administration of the Settlement arrangements.

At the Panel meeting on 13 December, the Panel will need to decide whether they agree with these arguments/assertions and decide whether or not to raise the Modification.

The Panel should note that Section F states that "such proposal shall be without prejudice to the Panel's decision, pursuant to paragraph 2.7, as to whether or not to recommend to the Authority that such modification should be made." I.e. if the Panel raise the Modification they are not required to recommend its approval to the Authority (and conversely, the Panel may raise the Modification even if they believe that their ultimate recommendation to the Authority may be to not recommend the Modification's approval.

3 Proposed Progression

Terms of Reference

If this Modification is raised we recommend that a Workgroup should be established to undertake an Assessment Procedure to consider the merits of the proposal, and that the Workgroup should comprise the P284 Workgroup (due to their familiarity with areas related to this governance issue) and the Governance Standing Modification Group.

Section 1 of this document outlined the history of this change and the amount of work and consultation already undertaken in this area. It is therefore recommended that the Terms of Reference for this Workgroup be as follows:

| Terms of Reference |
|--|
| Would there be benefit in BSCCo participating in the DCC bid process? |
| If successful, would there be benefit in BSCCo undertaking the DCC role? |
| Does the Modification meet the four Ofgem expansion criteria? |
| Are there any Alternatives? |
| What are the views against the Applicable BSC Objectives? |

Timetable

As noted above, the driver for this Modification is the DCC bid. The bid for the DCC must be submitted by 14th January 2013. Therefore, though we believe that Assessment of the Modification is appropriate, we recommend that its progression should take into account the pressing timescales associated with the DCC bid process.

A 'normal' Modification Progression timetable would look something like this:

| Step | Date |
|------------------------------------|-------------|
| Panel Meeting | 13 December |
| Modification Group | 18 December |
| Draft Consultation | 19 December |
| Issue consultation | 21 December |
| Consultation returned | 16 January |
| Modification Group | 21 January |
| Draft Assessment Report | 23 January |
| Assessment Report to Panel | 14 February |
| Report Phase Consultation issued | 15 February |
| Report Phase Consultation returned | 06 March |
| Report to Panel | 08 March |
| Report to Ofgem | 09 March |

Clearly it would not be possible to progress a Modification under "normal" timescales and still be able to meet the DCC timetable.

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Request for Urgency

Due to the tight timescales the BSCCo Board have requested that the Panel consider Urgency if they raise this proposal.

BSCCo suggest that this Modification would meet the Urgency guidance set down by Ofgem as it is:

"linked to an imminent issue (which may be date related) or a current issue that if not urgently addressed may cause a significant commercial impact on parties, consumers or other stakeholder(s)."

The Panel need to consider this request for urgency at the meeting on 13 December and decide whether or not to raise this modification as an Urgent Modification and make a subsequent recommendation to Ofgem to treat it as urgent. A proposed urgent timetable is outlined below:

| Step | Date |
|-----------------------|-------------|
| Panel Meeting | 13 December |
| Modification Group | 17 December |
| Draft Report | 17 December |
| Urgent Panel | 18 December |
| Consultation issued | 19 December |
| Consultation Returned | 02 January |
| Urgent Panel | 04 January |
| Report to Ofgem | 04 January |

Request for an expedited timetable

If the Panel do not wish to raise this Modification as Urgent then BSCCo request that it is progressed with an expedited timetable, because if an Ofgem decision cannot be received by 14 January 2013 the Modification is redundant.

A proposed timetable for an expedited process would be:

| Step | Date |
|-----------------------|-------------|
| Panel Meeting | 13 December |
| Modification Group | 18 December |
| Draft Report | 19 December |
| Ad hoc Panel | 20 December |
| Consultation issued | 20 December |
| Consultation Returned | 07 January |
| Urgent Panel | 08 January |
| Report to Ofgem | 08 January |

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4 Recommendations

ELEXON invites the Panel to:

- DETERMINE whether the attached Modification Proposal should be raised.

And, if the Modification is raised:

- AGREE that the Modification Group should be formed from members of the P284 Workgroup and members of the Governance Standing Modification Group;
- AGREE the Modification Group's Terms of Reference.
- DETERMINE whether the attached Modification should be treated as an Urgent Modification Proposal and a subsequent request for Urgent status issued to Ofgem;
- AGREE a timetable for progression of the Modification as an Urgent Modification Proposal; and
- AGREE an expedited timetable for the progression of the Modification if it is not requested that it be progressed as an Urgent Modification Proposal.

5 Further Information

More information is included in the draft Modification Proposal form which is attachment A and draft legal text which is Attachment B to this document.