

Modification proposal:	<b>Balancing and Settlement Code (BSC) P284: Expansion of Elexon's role via the 'contract model' (P284)</b>		
Decision:	The Authority <sup>1</sup> directs that the alternative proposal be made <sup>2</sup>		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	17 September 2012	Implementation Date:	18 September 2012

## Background to the modification proposal

The Balancing and Settlement Code ("BSC") was established pursuant to Standard Condition C3 of National Grid's Electricity Transmission Licence. The BSC sets out the powers, functions and constitution of the BSC Company ("BSCCo"), which is in effect the same company that is better known as "Elexon", a non-profit-making limited liability company established to facilitate the effective delivery, implementation, operation and development of the electricity trading arrangements.

The governance arrangements for Elexon (including corporate structure and funding) were set up with the sole aim of running the BSC arrangements. Elexon has identified opportunities to make use of its core skills and expertise in the provision of services outside of the BSC, which would enable it to earn additional revenues. The additional contribution to its fixed costs would in turn allow it to reduce charges to BSC Parties. Elexon also considers that the increased scope of its activities would improve its ability to offer better opportunities to, and therefore retain, its staff.

However, Section C1.2.2 of the BSC currently precludes Elexon from undertaking any business or activity which is not provided for in the BSC itself.

On 21 November 2011 we issued a consultation<sup>3</sup> on the potential expansion of Elexon, seeking views in particular on the conclusions of an independent report we had commissioned earlier.<sup>4</sup> The report suggested that there would be consumer benefits likely to arise from Elexon's diversification into other areas, but also highlighted certain additional risks to the BSC arrangements, and as a consequence of the current funding arrangements, to BSC Parties. The report concluded that while the subsidiary model initially put forward by Elexon could work, a contractual model would offer more robust safeguards.

In April 2012, following a thorough consideration of consultation responses and the possible implications that Elexon's diversification may have not only on the BSC but other areas of industry process, we published our own policy conclusions. We remained of the view that whilst there might be benefits of diversification, robust arrangements had to be put in place to mitigate any additional risk to the BSC and BSC Parties. In order to ensure that this was the case, we stated that our consent would be required and that we would need our pre-requisite conditions to have been met, as follows:

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

<sup>3</sup> See: [http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Elexon\\_Open\\_Letter.pdf](http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Elexon_Open_Letter.pdf)

<sup>4</sup> See: <http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/ElexonReportcovlet.pdf>

- 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.

We remained of the view that where the expansion into new areas would expose Elexon to significant risk a contractual model with a formal separation between the BSCCo and "New Elexon" offers the best means of meeting these criteria and thereby protect the interests of BSC Parties. However, we also suggested that there might be other, more proportionate, means of meeting them where the extent of risk was more limited.

### **The modification proposal**

Modification proposal P284 seeks to enable Elexon to carry out wider activities by making it an Agent of, rather than effectively being, the BSCCo. This would mean that whilst the BSCCo remains restricted to carrying out the activities set out in the BSC, the newly separated Elexon Company would be free to seek additional work, while continuing to provide BSC services to the BSCCo under contract.

The key features of this proposal are that:

- the BSC Services Manager would be governed in the same way as any other BSC Agent (such Agents already account for more than 50% of the BSC budget);
- the scope of the services would be set out in a Services Description document approved by the BSC Panel;
- any contract would have to deliver that Services Description.

The BSC workgroup developed an alternative proposal ("P284 Alternative") that seeks to do everything that the original does, but with the additional requirements that:

- the contract principles must be consulted upon; and
- the BSCCo requires the Authority's confirmation that it is satisfied that its pre-requisite conditions (as set out in the April 2012 conclusions letter) have been met.

### **BSC Panel<sup>5</sup> recommendation**

At its meeting of 9 August 2012 the BSC Panel voted unanimously to recommend that P284 should not be made. The Panel members considered that none of the relevant objectives of the BSC would be further facilitated, as the risk associated with the proposal would outweigh any of the benefits against objective d).

The Panel also voted by a majority to recommend that the P284 Alternative not be made, with the same concerns being cited as for the original. However, a minority of Members considered that the additional controls within the Alternative should adequately protect the BSC arrangements, therefore allowing the benefits against objective d) to be realised.

### **The Authority's decision**

We have considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 10 August 2012. We have considered and taken into account the responses to Elexon's<sup>6</sup> consultation which are attached to the FMR<sup>7</sup>. We have concluded that:

<sup>5</sup> The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC.

<sup>6</sup> The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.

1. implementation of the P284 Alternative would better facilitate the achievement of the relevant objectives of the BSC<sup>8</sup>; and
2. directing that the modification be made is consistent with our principal objective and statutory duties<sup>9</sup>.

### **Reasons for the Authority's decision**

In coming to our decision on P284 and the P284 Alternative, we have not sought to consider the benefits to competition in non-BSC services which may result from enabling Elexon to bid. Nor have we at this stage sought to anticipate the likely scope, value or duration of any BSC Services Management contract. We consider this to be more appropriately a matter for the BSCCo Board.

To the extent that either P284 or the Alternative proposal would enable, but not require, the BSCCo Board to explore the potential benefits of outsourcing some or all of those activities currently carried out in-house by Elexon, we agree with the proposers and those respondents who suggested that either of these proposals would simply be an enabling modification. Our focus is therefore on whether the costs of the BSCCo carrying out such an exercise would be efficient, and therefore agree with the BSC Panel that these proposals should be assessed against relevant objective d) only, as there is no obvious impact upon the other BSC objectives.

*BSC Objective d) - "Promoting efficiency in the implementation and administration of the balancing and settlement arrangements".*

It is generally accepted that there are circumstances where outsourcing can provide an effective means of driving down costs, particularly where the service provider is able to realise economies of scale and scope that are not open to the purchaser. However, this is not universally the case and can depend on factors such as the substitutability of specialist staff, transfer of knowledge and confidence of customers, etc. Indeed we have recently approved a modification to the BSC which enabled Elexon to bring a service back in-house where it was unable to procure an efficient offering through competitive tender<sup>10</sup>. We therefore consider that it is no longer appropriate for the BSC to prescribe how those activities that could be reasonably captured under a BSC Services Manager description should be procured, but instead that the BSCCo Board should be given the authority to consider the circumstances at any given time and make an informed choice. We therefore welcome the fact that P284 and the Alternative would merely enable the BSCCo Board to enter into such a services contract, but does not require them to do so.

We note that the majority of respondents that were opposed to the P284 original and, to a lesser extent, the Alternative, stated they were not opposed to Elexon's diversification in principle, but were unable properly to assess the benefits without a robust business case and/or the details of the contract. We have sympathy with this view, but also recognise the paradox faced by the BSCCo Board and Elexon, in that it will be required to expend time and resources in order to develop and assess the benefits of a service management contract which could then justify a modification to the BSC, but there is no clear authority to spend that time and money while the current BSC prohibition remains.

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<sup>7</sup> BSC modification proposals, modification reports and representations can be viewed on the Elexon website at [www.elexon.com](http://www.elexon.com)

<sup>8</sup> As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: <http://epr.ofgem.gov.uk/index.php?pk=folder380751>

<sup>9</sup> The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989.

<sup>10</sup> [P255](#): "Profile administrator: creating flexibility in discharging the service"

P284 and its Alternative would therefore break that circle, enabling the substantive decisions to be subsequently made on the basis of a robust assessment.

Whilst we consider that any future the contract would effectively act as a “firewall”, ensuring that BSC Parties are not required to fund additional start ups or losses, there are also risks to standards of services and for the first time a possibility, however remote, of failure of the BSC Services provider. These risks can be expected to be mitigated by the provisions of the contract, although the BSCCo will continue to incur costs in managing that contract and it is reasonable for BSC Parties to expect some further benefit to offset these additional risks.

We understand that any contract developed in the near term is expected to be on an ‘as is’ basis, capturing the services (and standards of performance for those services) that Elexon currently perform. There may therefore be limited scope for further value added services, although these could be expected to evolve over time. The immediate benefits are therefore likely to be in the form of realisable cost savings over and above those reasonably expect under the existing arrangements.

Whilst there is currently little certainty on what the BSCCo Board may spend leading up to its determination on whether or not to pursue the contract model, we note that Elexon has estimated costs at £200k-£500k, as cited in its paper to the August 2012 BSC Panel meeting.<sup>11</sup> That paper also cited potential net benefits of £2.3m-£13.9m from adopting the contract model, although £3.2m-£9.5m of benefits are attributed to the future tendering that would only take place towards the end of the contract. We have not sought to validate these figures or produce our own detailed analysis as we consider that is properly a matter for the BSCCo Board to take forward. However, we consider that under each of the reasonable scenarios, the expected range of benefits as compared to its own costs make it proportionate and appropriate for the BSCCo Board to further explore its options.

We also consider that there will be benefits to this proposal even if the BSCCo Board decides not to pursue the contract model at this time. As stated in Elexon’s own submission, cost savings that have been achieved to date have been driven by management rather than as a natural consequence of the governance arrangements. In providing the BSCCo Board with the credible option of outsourcing there will be a continuing pressure on Elexon’s management to ensure that it remains efficient. Furthermore, now that it has the vires to do so, the BSCCo Board may carry out periodic market testing to ensure that this remains the case.

It should be noted that we do not consider this to be in any way contingent upon Elexon’s success in its stated aspiration to compete in the competition to become the Data Communications Company (“DCC”), as set out its Business Plan for 2011-12.<sup>12</sup> We share the view of Elexon that the arrangements must be fit for purpose for generic diversification. We would expect the initial contract to factor in the anticipated contribution from new activities to fixed costs, but if the New Elexon is unsuccessful with its initial bids, it must identify and pursue appropriate opportunities elsewhere.

We consider that either P284 or the Alternative would create an opportunity for the BSCCo Board to deliver greater value for BSC Parties and are therefore equally capable of delivering benefits against relevant objective d). However, we note the degree of discomfort of some BSC Parties with this process. Although the additional steps involved in the P284 Alternative will create an additional administrative burden, we do not

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<sup>11</sup> [BSC Panel paper 201/09: An assessment of the benefits of adopting the Contract Model](#)

<sup>12</sup> See: [www.elexon.co.uk/pages/corporateandfinancialinformation.aspx](http://www.elexon.co.uk/pages/corporateandfinancialinformation.aspx)

consider this to be material. Furthermore, in establishing a greater degree of certainty and comfort with the contractual arrangements, the Alternative may negate the number of additional queries and secondary consultation and scrutiny that may be required. We are therefore satisfied that the additional steps would be an efficient means of ensuring that the contract meets our prerequisite criteria and that overall the Alternative is the better of the two proposals.

For the avoidance of doubt, we do not anticipate that we will receive, nor will we seek to endorse, the contract in full.<sup>13</sup> We are interested only to the extent that our pre-requisite criteria are to be met through provisions of the proposed contract, and we expect that in large part these will already be captured in the contract principles that are themselves subject to consultation. We consider that this may involve a report from, or detailed dialogue with, the BSCCo Board to understand its rationale and intentions. We expect that the process will continue until such point as we are satisfied that the criteria have either been met, or patently cannot be.

#### *Statutory duties*

Whilst the benefits of Elexon's participation may not directly be a consideration for the BSC objectives, we consider that it should be able to identify synergies and generally improve the degree of competition to undertake emerging activities. Whilst we have no views on the relative merits of Elexon to undertake this role in comparison with any other bidder, we consider that the existence of additional bidders should improve the extent of competition, benefiting the electricity industry and in principle putting a downward pressure on the costs that will be passed through to electricity consumers.

Whilst these considerations may not be directly relevant to the furtherance of the BSC objectives, we consider that they are consistent with our wider statutory duties.

#### *Further views*

We consider that it would be appropriate for the BSCCo Board and BSC Parties more generally to give further consideration to a more limited diversification under the existing structure. In our April letter we indicated that whilst we remained of the view that a contractual model was the most robust means of safeguarding the BSC arrangements and BSC Parties from significant risk, there might be more proportionate safeguards where the additional risks were more limited. For example, in the absence of the contract model, it may still be appropriate to enable Elexon to take on roles outside the BSC, to the extent that the BSCCo Board is satisfied that this would create value and not jeopardise the core arrangements. It is disappointing that this option does not appear to have been pursued further, particularly as, even with the implementation of P284 alternative, the BSCCo remains prohibited from taking on such activities.

#### **Decision notice**

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority hereby directs that modification proposal P284 Alternative be made.

**Andrew Burgess**

**Associate Partner, Transmission and Distribution Policy**

Signed on behalf of the Authority and authorised for that purpose.

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<sup>13</sup> We acknowledge that the legal text of P284 Alternative may be considered ambiguous on this point. However, we do not understand it to require the full text of the contract to be sent to the Authority.