Modification proposal:	**Balancing and Settlement Code (BSC) P289: Enabling Elexon to participate in tendering for the DCC licensee roles via a subsidiary(P289)**		
Decision:	The Authority[1] has decided to reject this proposal[2]		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	24 January 2013	Implementation Date:	n/a

Background to the modification proposal

The BSC was established pursuant to Standard Condition C3 of National Grid's electricity transmission licence. Section C of the BSC sets out the powers, functions and constitution of the BSC Company (BSCCo), which is responsible for administering the BSC and delivering balancing and settlement services.[3] Elexon is a non-profit-making, limited company established to be the BSCCo.[4] By virtue of paragraph 1.2.2, Section C, BSC, Elexon may not undertake any business or activity other than as provided for in the BSC.

Elexon's 2011/12 Annual Report identified opportunities for Elexon potentially to provide services outside of the BSC. Following industry and Ofgem assessment and consultation,[5] in April 2012,[6] we concluded that there may be industry advantages to the diversification of Elexon's role subject to certain conditions, including the condition that BSC parties should benefit from such diversification.[7] We indicated that a so-called 'contract model' – whereby a new BSSCo would be established and contract out a number of its operations on an arm's length basis to an independent, unregulated Elexon - may be an appropriate mechanism for achieving diversification. We also said that there may be other, potentially more proportionate options that could be explored.[8]

In September 2012, we approved P284 Alternative,[9] which enabled Elexon to develop a potential contract model, subject to Ofgem being satisfied that any contract met our diversification conditions. In November 2012, the BSCCo's Board decided not to pursue a 'contract model', as it could not be satisfied that our conditions were met by such a model. In particular it was concerned about the extent to which BSC parties could benefit under this model. The Board considered there may be benefits to Elexon diversifying, in particular in relation to the opportunity to bid in DECC's tender process for

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989
[3] In 2011 Standard Condition C3 and the BSC were amended to enable Elexon to operate the reconciliation mechanism under the government's Warm Home Discount (WHD) scheme, in addition to its BSC activities.
[4] 'Elexon' and 'the BSCCo' are used interchangeably in this document.
[5] Information on the 'Issue 40' industry review is available on Elexon's website (www.elexon.co.uk). In addition, in 2011, Ofgem commissioned an independent report and consulted on options: http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/Elexon_Open_Letter.pdf
[6] http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/elexon%20expansion%20way%20forward%20letter%20300412.pdf
[7] The four conditions are 1.BSC Parties should benefit from any diversification; 2. The arrangements should not place disproportionate risk on BSC Parties; 3. Standards of service under the BSC should be maintained; and 4. Elexon's BSC role should not give it any undue competitive advantage in a contestable activity.
[8] For the avoidance of doubt, this decision addresses the proposed BSC modification P289 and is not intended to express views, or reflect any change in the Authority's position, on the wider issues surrounding Elexon's ambition to expand its business model, including that the Authority in principle does not oppose expansion by Elexon where this is in line with the applicable licence and BSC rules and meets our four conditions.
[9] http://www.ofgem.gov.uk/Licensing/ElecCodes/BSCode/BSC/Documents1/P284D.pdf

the appointment of a smart metering Data Communications Company (DCC). The Board requested that Elexon explore how it would be able to participate in the DECC tender. As the Final Modification Report (FMR) for P289 makes clear, Elexon cannot participate in the bidding process under the current BSC drafting, which precludes Elexon or its subsidiaries undertaking work outside the BSC.

In December 2012, the BSCCo Board requested that the BSC Panel raise a modification seeking to enable it to participate in this process, and requested that it be treated as an urgent modification.

The modification proposal

On 13 December 2012, the Panel agreed to the BSCCo Board's request to raise P289. The Panel did not agree that the proposal should be treated as urgent, but did agree to an expedited timetable for consideration of the proposal.

P289 seeks to establish a new subsidiary to the BSCCo, which would participate in the tender for the appointment of the DCC and, if successful, would undertake the DCC role. BSCCo would be the sole shareholder of the new subsidiary – referred to as the DCCCo. All DCCCo declared dividends would be paid to BSCCo to offset BSC costs. Initial set up of DCCCo and its costs of participating in the DECC tender process would be funded by BSC parties up to the sum of £600,000 (£300,000 for internal BSCCo resources and £300,000 for external costs such as legal costs). This sum would be a loan from BSCCo to DCCCo, to be repaid if DCCCo were successful in its bid.

Working group assessment

The expedited timetable provided for one industry working group meeting to assess P289. The Working Group met on 17 December 2012.

The majority of the Working Group identified either no benefit or detrimental impact against objective (d) (promoting efficiency in the implementation and administration of the balancing and settlement arrangements), including because they considered it would effectively introduce a mandatory obligation on BSC Parties to fund non-BSC activities and would introduce a risk around delivery and quality of BSC services. The minority of the Working Group identified benefits against objective (d), including potential efficiency savings and DCC dividends offsetting BSC costs (which they considered outweighed the cost of a DCC bid).

One Working Group member considered P289 would have a detrimental impact against Applicable Objective (a) (the efficient discharge by the licensee of the obligations imposed upon it by the licence), as it was concerned that P289 would expand the scope of BSC activities beyond that described in the Transmission Licence. Another identified a detrimental impact against Applicable objective (c) (promoting effective competition in the generation and supply of electricity) on the basis that introducing a risk to maintaining the standard of BSC services, and mandating Parties to fund non-BSC services, would not promote effective competition.

The Working Group identified two potential alternatives to P289, but these were not developed in any detail as a result of the expedited process.

Following the Working Group meeting, on 20 December 2012, the BSC Panel agreed to issue the P289 draft modification report for consultation. The majority of respondents to the consultation did not support P289, and many criticised the process that had been followed in developing the proposal.

BSC Panel[10] recommendation

At its meeting on 15 January 2013, the Panel voted by majority that P289 would not better facilitate the Applicable BSC Objectives and should therefore be rejected.

The Panel unanimously considered that P289 is neutral against Applicable Objectives (b), (c) and (e).

The majority of the Panel considered that P289 would not better facilitate Applicable Objective (d) as the financial risks outweighed any potential benefit and BSC Parties would be mandated to fund a bid. The Panel also considered that (i) the costs associated with the DCC bid are a definite detriment, whilst (ii) benefits from dividends are not guaranteed even if DCCCo is successful in the DECC tender process and that (iii) there is insufficient evidence that measures to ring fence BSC and DCC resources would be adequate. The majority of the Panel considered that P289 would not better facilitate Applicable Objective (a) on the basis that if it has a detrimental impact on (d) (and no impact on the other objectives) it also impacts (a) in relation to the efficient discharge of Transmission Licence obligations.

The minority of the Panel considered the proposal would better facilitate Applicable Objective (d) as the potential benefits outweigh the risks.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the FMR we received on 23 January 2013.[11] The Authority has considered and taken into account the responses to Elexon's[12] consultation on the modification proposal, which are attached to the FMR.[13]

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the applicable objectives of the BSC.[14]

Reasons for the Authority's decision

We note that some respondents to the industry consultation, including National Grid, considered that P289 could not be approved absent an amendment to Standard Condition C3 of the Electricity Transmission Licence.

Standard Condition C3 requires National Grid to establish a code addressing the matters

[10] The BSC Panel is established and constituted pursuant and in accordance with Section B of the BSC.
[11] We were sent an FMR on 16 January, but with no supporting legal drafting setting out the proposed BSC changes. The FMR was re sent, with legal drafting, on 18 January. In the afternoon of 21 January, we were advised that the legal drafting was not accurate, as it did not reflect amendments that had been agreed with the Panel. We received the amended legal drafting on 23 January.
[12] The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.
[13] BSC modification proposals, modification reports and representations can be viewed on the Elexon website at www.elexon.com
[14] As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: http://epr.ofgem.gov.uk/Pages/EPRInformation.aspx?doc=http://epr.ofgem.gov.uk/EPRFiles/Electricity+transmission+full+set+of+consolidated+standard+licence+conditions+-+Current+Version.pdf

specified in that condition – namely, balancing and settlement arrangements. The purpose of the code and the code administrator are expressly tied under this Condition to the balancing and settlement functions. P289 seeks to enable Elexon's subsidiaries to perform a role (the DCC role) that falls outside the scope of the balancing and settlement arrangements as defined in the current version of the Licence. We do not consider that the power to modify the BSC under Standard Condition C3(5)(a) of the Transmission Licence can properly be used to introduce into the BSC provisions that bear no relation to the purpose of the BSC. Lawful modifications clearly need to relate to the balancing and settlement arrangements, as opposed to extraneous matters including alternative unrelated businesses. Accordingly, we consider that it would be an improper use of the power to modify the BSC to enable a subsidiary of the code administrator to take up the new intended DCC role, in the absence of an appropriate amendment to the Electricity Transmission Licence.

In summary, BSC modifications should only be made for a purpose which is consistent with the scheme of Standard Condition C3, which concerns the proper execution of a balancing and settlement function; this does not include undertaking extraneous business activities, however profitable they may appear to be. National Grid's Transmission Licence would need to be amended (as was done in the case of the Warm Homes Discount scheme) to allow such additional business activities to be included in the BSC.

Independently of this objection we have nonetheless also gone on to consider carefully P289 on its merits and the views expressed in its support and in opposition, and whether or not it would better facilitate the Applicable Objectives of the BSC. Following such consideration, we are in agreement with the majority view of the Panel and with the majority of respondents to Elexon's consultation who do not support P289. On balance, we consider that insufficient evidence has been presented to demonstrate that P289 better facilitates the Applicable Objectives. We broadly agree with the assessment of the majority of the Panel as set out in the FMR and agree with their recommendation that the modification should be rejected. In particular, we agree with the Panel that it is not appropriate effectively to mandate BSC parties to pay for a non-BSC service, when the potential benefits are uncertain and have not been quantified. As set out above, we also consider that approving P289 is not consistent with National Grid's transmission licence.

We note that some of the Panel and a number of respondents to Elexon's consultation raised concerns with the process and timetable for consideration of P289 that has been followed. We also have similar concerns in relation to the expedited process which, amongst other things, prevented potential alternatives that were identified by the Working Group from being developed and assessed.[15] We welcome that the Panel has agreed to consider these process concerns separately and in depth. We think it is important that any potential concerns are addressed in a timely manner. It is important for industry to have confidence in the balancing and settlement arrangements, the body responsible for administering those arrangements and the Panel, as the efficient operation of these arrangements is central to electricity trading in GB.

Hannah Nixon,
Senior Partner, Smarter Grids and Governance: Distribution
Signed on behalf of the Authority and authorised for that purpose.

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[15] We wrote to the BSC Panel Chair when P289 was first raised, setting out our concerns on the proposed timetable: http://www.elexon.co.uk/wp-content/uploads/2012/05/206_17_Letter_from_Ofgem.pdf