Modification Proposal – BSCP40/03	MP No: P289

Title of Modification Proposal:
Enabling ELEXON to participate in tendering for the DCC Licensee role via a subsidiary.

Submission Date:
13 December 2012

Description of Proposed Modification:
This proposal seeks to enable a subsidiary of ELEXON (known as "Smart Co") to participate in the tender exercise for the Data Communication Company (DCC). 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 Licensee via a group company. We refer to "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 the DCC Licensee role, 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 DCC Tender Costs (see below);

- BSCCo may not place Smart Co in breach of its legal requirements (e.g. DCC licence obligations);

- The Board of BSCCo will appoint the initial chairman of Smart Co. The initial chairman of Smart Co will in consultation with the Panel 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 (existing Section C, paragraph 3.4.5(c)).

Funding of DCC Licensee bid

- Subject to the following conditions, ELEXON may provide funding for the award of the DCC Licensee role 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

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Licence/contract ("DCC Tender Costs"). These conditions are:

(i) Third party costs incurred in connection with the DCC Tender exercise (e.g. professional advisor costs) will be limited to £300,000[1];
(ii) Smart Co's overheads (e.g. personnel costs) incurred in connection with the DCC Tender exercise will be initially met by BSCCo but subject to a statement of account at the conclusion of the bid activities;
(iii) DCC Tender Costs must be at arm's length and on normal commercial terms[2];
(iv) DCC Tender Costs will be subject to ELEXON's statutory audit;
(v) If Smart Co is awarded the DCC Licensee role, Smart Co will repay aggregate DCC Tender Costs in respect of that successful bid to ELEXON within a defined period.[3] For the purposes of repayment, Aggregate DCC Tender Costs 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 the DCC Licensee role ELEXON will write off the DCC Tender Costs 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; and
(viii) ELEXON will be under an explicit BSC obligation to procure that Smart Co provides reports to ELEXON at regular intervals on DCC Tender Costs (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 affiliate[4];

- If Smart Co is awarded the DCC Licensee role 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); and

- 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

[1] There is sufficient underspend in the 2012/2013 Annual Budget to cover the DCC Tender Costs.
[2] This provision reflects, in part, Standard Condition B9 of NGET's transmission licence.
[3] It is suggested that this period should be a maximum of 12 years to reflect the duration of the initial DCC licence period.
[4] This provision reflects Standard Condition B5 of NGET's transmission licence.

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explicit BSC obligation to ensure that at all times it has sufficient resources (including personnel) to fully discharge its BSC responsibilities.

This Modification Proposal includes draft legal text to implement this solution in the BSC, but which is put forward for review, consideration and development by a Modification Workgroup.

Description of Issue or Defect that Modification Proposal Seeks to Address*:*

The current BSC drafting means that ELEXON Ltd may not partake in the tender process for the DCC Licensee role. We believe this prevents ELEXON from leveraging its skills and expertise for the wider benefit of the industry, which could be detrimental in the delivery of the most efficient and economic Smart Meter solutions.

The key constraints currently imposed on ELEXON Ltd by the BSC include provisions preventing:

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

Impact on Code:

Amendments to 'Section C: BSCCo and its Subsidiaries' and Section X 'Definitions and Interpretation'

Impact on Core Industry Documents or System Operator-Transmission Owner Code*:*

None identified

Impact on BSC Systems and Other Relevant Systems and Processes Used by Parties:

None identified

Impact on other Configurable Items:

None identified

Justification for Proposed Modification with Reference to Applicable BSC Objectives:

In November 2011 Ofgem consulted on the potential expansion of ELEXON's vires to allow it to take on additional work beyond that set out in the Balancing and Settlement Code (BSC). This was driven primarily by ELEXON's desire to participate in the Government's anticipated competition to operate the Data and Communications Company (DCC). But it was envisaged that any potential changes to the BSC would also enable ELEXON to have the opportunity to take on other roles; in particular the administration of the Smart Energy Code (SEC) and emerging roles from the proposed Electricity Market Reform (EMR). As part of this work ELEXON identified benefits from defraying its existing fixed overheads over wider revenues, utilising profits from new businesses to reduce BSC Parties' costs, creating a new competitor in the central body market place and potentially acting as a consolidator of central body services.

The conclusions of the Ofgem consultation were published in April 2012 and set out four conditions

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that would need to be satisfied before any expansion could occur, with the aim of protecting the BSC Parties and ultimately consumers.

The four expansion conditions 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.

Ofgem's proposed mechanism to achieve the expansion was a change to the BSC which would enable the BSCCo Board to outsource its activities to a new entity ('New 'ELEXON') under a for-profit contract. 'New 'ELEXON' would be a new company independent of BSCCo and National Grid and would therefore be able to pursue new activities in addition to providing BSC services to BSCCo. This approach was known as the "contract model" and was introduced into the BSC via P284 in September 2012. Prior to the raising of P284, in its April 2012 conclusions, Ofgem had acknowledged concerns raised by several respondents that a contract model may be 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 a contract with the BSCCo Board.

On 27 November, ELEXON's Board concluded that, whilst it believes ELEXON diversification will undoubtedly bring longer term benefits to consumers, the industry, Government and to staff, the proposed contract model could not meet all of Ofgem's four expansion conditions and therefore the contract model could not be pursued at this time. The Board was unable to reconcile Ofgem's condition 'BSC Parties should benefit from diversification' where that meant a shift from a not for profit to a for profit service which, coupled with increased overheads arising from the need for two companies (customer and provider) where there had been only one in the past, 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.

Separately, the BSCCo Board has clearly communicated it supported ELEXON's aspirations to undertake new central roles, the most immediate of which is the DCC and that it is a matter of finding the appropriate mechanism to enable the expansion.

We believe the BSCCo Board was right in its decision for the reasons it states. We also believe that since Ofgem published its consultation conclusions, the role of the DCC has been significantly de-risked and many of the uncertainties clarified. In particular:

- The DCC is not liable for the breaches of its subcontractors;
- The DCC will have a funding arrangement similar to that of the BSC and is therefore able to properly fund its activities from Licence award, without the need to seek independent financing or security (other than short term working capital by way of bank loan to the DCC); and

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- Role clarity, i.e. manage DCC service providers, provide prescribed services to DCC Parties and re-procure services as required.

As a result we believe that this Modification provides a more proportionate means of allowing a limited expansion of ELEXON to undertake the DCC role via a separate group company. If a separate Modification is desired to allow ELEXON to undertake other activities in accordance with Ofgem's "limited expansion" model as described in its 30 April conclusions letter, such Modification would be separate to this DCC Modification.

We are also aware that as part of the implementation of the 'contract model' a separate company, The ELEXON Partnership Limited - unconnected to ELEXON/BSCCo - submitted a response to DECC's DCC Pre-Qualification request. It is public knowledge that this company "qualified" along with three other PQ respondents to the next phase of the DCC award process. It now has until mid January 2013 to submit an ITA response.

It is our view that ELEXON's continued participation in the DCC award process will ensure that this process has the maximum competitive tension arising from an appropriate number of bidders. Even if ELEXON is ultimately unsuccessful, it is our view that its participation will have depressed tender prices and improved the offers of competing bidders, all to the benefit of Government, electricity and gas suppliers and ultimately the consumer.

Applicable BSC Objectives

(d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements

- 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 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

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returned to Parties, reducing the costs of running the BSC and ultimately increasing the efficiency in the administration of the Settlement arrangements.

Ofgem's Expansion Criteria

In addition to the Applicable BSC Objectives we also believe that this Modification Proposal meets the expansion criteria as set by Ofgem as detailed below:

1. BSC Parties should benefit from any diversification

Benefits specific to BSC Parties:

- Opportunity to defray BSC fixed overheads - In the BSCCo Business Plan 2011/12 ELEXON estimated that if it undertook new central smart metering roles alongside the BSC role, BSC Parties would benefit from an annual reduction in BSCCo costs arising from recharging a proportion of BSC fixed costs to Smart Co. At the time this was estimated to potentially exceed £1m per year, and would therefore represent a saving in excess of £12m for BSC Parties over, for example, the life of the initial DCC licence award period;
- Dividends will be remitted from Smart Co to BSCCo and used to further offset BSC Parties costs. Note: The level of dividends cannot be stated here as this may compromise the commerciality of any ITA response;
- Mitigates the adverse impact on settlement that a failure of the DCC infrastructure would have through disrupting the flow of metered data and possible misallocation of energy resulting in severely compromised data quality. ELEXON, through its BSCCo role, has an overwhelming imperative to ensure that the DCC arrangements function efficiently and effectively. This argument is strengthened when considering ELEXON's natural incentive to drive the roll-out since ELEXON 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.

Wider benefits to the marketplace:

- Creating a new competitor/consolidator amongst the small field of players capable of delivering central market arrangements. The participation of the new entrant in competitive processes will deliver benefits to the market, even if that new entrant is not ultimately awarded the role. A new contract could also facilitate market consolidation allowing synergetic benefits to be realised;
- The ability to diversify will foster innovation and creativity in the delivery of all services and this will benefit both BSC Parties and the wider market place.

2. The arrangements should not place disproportionate risk on BSC Parties

- Creation of a separate Smart Co group company in order to legally ring fence liabilities from BSCCo. This business separation is typical of companies undertaking different business activities, where one business is protected via limited liability status, from the activities of its subsidiaries. This arrangement is entirely consistent with the existing ownership arrangement between BSCCo and its owner National Grid;

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- BSCCo will be the sole shareholder in Smart Co
- Smart Co established as a "single purpose vehicle" for the purpose of discharging DCC obligations only;
- No pledging of BSCCo assets;
- BSCCo not required to provide any form of financial or other guarantee.

3. Standards of service under the BSC should be maintained

- The BSC already includes clearly defined services and BSC Agent contracts require them to meet a range of comprehensive service levels. Furthermore, service credits are invoked for non-performance;
- New explicit BSC obligation requiring BSCCo to ensure that it is adequately resourced to discharge its BSC obligations;
- An expanded ELEXON will improve staff retention and morale, ensuring expertise is available to industry for longer thus ensuring there is no degradation in service standards due to a failure to retain key staff;
- Existing governance provides mechanisms to ensure that service standards are maintained;
- Continued delivery of the core BSC service to BSC requirements and Parties' expectations is the bedrock upon which ELEXON's reputation is built. It would not therefore be in ELEXON's interests to jeopardise the continued delivery of the core BSC service.

4. ELEXON's BSC role should not give it any undue competitive advantage in a contestable activity

- BSCCo IP and other assets available to Smart Co on BSC or other agreed rates;
- No cross subsidy;
- Each legal entity will be audited; this will ensure that appropriate charges for the use of shared assets and resources are appropriate;
- Ofgem has indicated that if conditions 1 and 2 are met, then condition 4 is also met.

Is there a likely material environmental impact?
No

Urgency Recommended:
No

Justification for Urgency Recommendation*:*
N/A

Self-Governance Recommended:
No

Justification for Self-Governance Recommendation:
N/A

Should this Modification Proposal be considered exempt from any ongoing Significant Code Reviews?
Yes. This Modification does not relate to any on-going SCR.

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Attachments: Yes – Attachment A Draft Legal text	

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