



March 2004

**Modification Proposal P161**  
**“Enhancement of BSCCo Board**  
**Structure”**

**Consultation Document**

(Prepared by ELEXON on behalf of the  
Governance Standing Modification Group)

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## 1 INTRODUCTION

Modification Proposal P161 "Enhancement of BSCCo Board Structure" (P161) was raised by National Grid Transco (the Proposer) on 30 January 2004. P161 proposes that two new 'executive director' positions should be added to the BSCCo Board of Directors (the Board) to improve the corporate governance of BSCCo.

According to the Proposer, the current Board structure is not in line with the "best practice model" for corporate governance in that its membership does not include the BSCCo Chief Executive or a senior commercial/financial post holder from within BSCCo. Under the proposal, the BSCCo Chief Executive and a senior BSCCo executive, holding a commercially and financially orientated position, would be added to the Board as Directors.

An Initial Written Assessment (IWA) of P161 was considered by the BSC Panel (the Panel) at its 12 February 2004 meeting. The Panel, in accordance with BSCCo's recommendation, submitted P161 to a two-month Assessment Procedure. The Governance Standing Modification Group (GSMG) was assigned to carry out the Assessment Procedure with the following additions to the standard Terms of Reference:

1. Assess the case for the inclusion of Executive Directors on the Board (i.e. advantages of Executives as Directors rather than attendees);
2. Assess the case for specifying that a senior BSCCo executive holding a commercially and financially orientated should be added to the Board (i.e. should the appointment of the second executive be restricted to such a post holder?);
3. Assess the proposed Board structure in light of the original rationale for the current Board structure (i.e. an entirely non-Executive membership and the existing balance between Industry and Other Directors); and
4. Assess whether the proposed Board structure would be appropriate for a Non-Profit Organisation such as BSCCo.

This consultation document provides background information (i.e. details of the current and proposed Board structures) and the GSMG's initial assessment of the issues identified in the Assessment Procedure Terms of Reference.

To assist its assessment of P161, the GSMG is seeking feedback from interested parties. A questionnaire accompanying this consultation document contains a set of questions to which interested parties are invited to respond. **Responses should be sent to [modification.consultations@elexon.co.uk](mailto:modification.consultations@elexon.co.uk) by 12:00 on 19 March 2004.**

## 2 MODIFICATION GROUP MEMBERSHIP

The membership of the GSMG, for the purpose of undertaking the P161 Assessment Procedure, is as follows:

Member	Organisation	Email Address
David Warner	ELEXON (Chairman)	David.Warner@elexon.co.uk
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James Nixon	Scottish Power	James.Nixon@saic.com
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Mark Manley	BGT	Mark.Manley@centrica.co.uk
Neil Smith	Powergen	neil.c.smith@pgen.com
Terry Ballard	Innogy	Terry.Ballard@npower.com

In addition, the following persons attended one or more P161 Modification Group meetings:

<b>Attendee</b>	<b>Organisation</b>	<b>Email Address</b>
Jerome Williams	Ofgem	Jerome.williams@ofgem.gov.uk
Gareth Forrester	ELEXON	Gareth.forrester@elexon.co.uk
David Ahmad	ELEXON	David.ahmad@elexon.co.uk

Please note that there is a clear distinction in role of the ELEXON GSMG members and the ELEXON attendees:

- The ELEXON GSMG members, David Warner and Roger Salomone, were charged with acting impartially in support of the GSMG as Chairman and Lead Analyst respectively.
- The ELEXON attendees were present at the first meeting to provide information. David Ahmad, an ELEXON legal advisor, was present to provide information on the legal role and duties of a Board and its Directors. Gareth Forrester, manager of ELEXON's Governance and Regulatory Affairs team, was present to provide the ELEXON view on P161.

As a consequence, any reference in this document to an ELEXON view refers to the views of the ELEXON attendees, and not the ELEXON GSMG members.

### **3 CURRENT BOARD STRUCTURE**

#### **3.1 Membership**

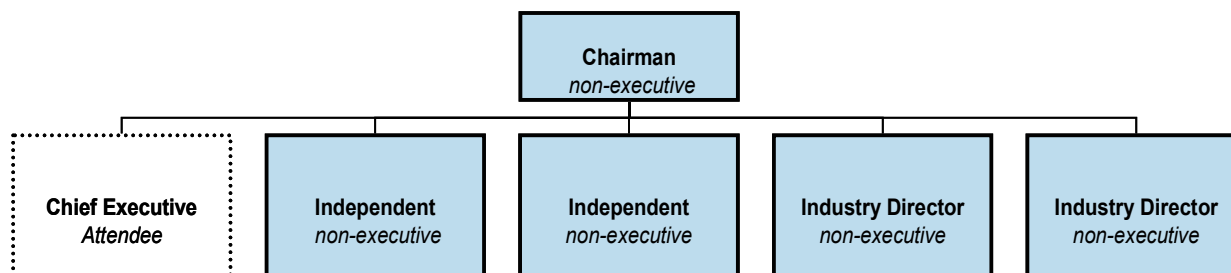
Currently, the Code requires that the Board shall comprise five 'Directors' as follows:

- Chairman of the Board (who shall also be the Panel Chairman);
- 2 Industry Directors (Industry Panel members nominated by the Panel); and
- 2 Other Directors (persons nominated by the Panel Chairman after consultation with the Panel).

Under paragraph C4.6 of the Code, the BSCCo Chief Executive is entitled to attend and speak at all meetings of the Board. However, the Chief Executive is explicitly prohibited from being a Director (C4.6.1 and C4.6.3).

The diagram A below provides an overview of the current Board structure and membership:

#### **Diagram A**



### 3.2 Rationale

The GSMG noted the Ofgem consultation on the design of NETA in 1999. As part of that exercise, the corporate governance of BSCCo was consulted on. The proposal consulted on was that the Panel would act as and perform the role of the BSCCo Board<sup>1</sup>.

However, after consultation, Ofgem/DTI concluded that the Board should be smaller in size than the Panel and decided on the present structure/membership. The following extract from the conclusions document summarises the view:

**"BSC Board**

*The Chairman and the Panel will select four persons to become non-executive directors of the BSCCo and to form the BSCCo Board. Ofgem/DTI feel that the Board should be smaller in size than the Panel, as a smaller body is better able to exercise the required level of scrutiny and control of the BSCCo. Two of the directors will be drawn from the industry members of the Panel. The remaining two directors could be selected either from within the remaining Panel members or from outside, if particular skills were required on the Board that were not present among the Panel membership. For example, the Chairman might want to have accounting and IT advice available to him on the Board. The Board responsibilities will include the approval of the BSCCo business plan and budget and the monitoring of performance. The fact that the Board will be non-executive, and include representatives of those paying BSCCo fees, should reassure participants that there will be sufficient transparency, scrutiny and control of costs.<sup>2</sup>*

The GSMG noted that the Ofgem/DTI conclusions, as represented by the 1999 'Conclusions Document', suggested that three key considerations were key to the rationale for the current Board structure:

- **Size** (i.e. the Board should be sufficiently small to exercise effective scrutiny and cost control)
- **Mix of Skills** (i.e. Board members, collectively, should possess the skills required for the Board to function effectively)
- **Independent Scrutiny** (i.e. a non-executive membership, including directors with an 'industry perspective', should provide assurance that BSCCo would be subject to effective scrutiny and cost control)

<sup>1</sup> See Chapter 10 "Governance" in "The New Electricity Trading Arrangements: Volume 1" (July 1999), available on the Ofgem website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)).

<sup>2</sup> See p.174 "The New Electricity Trading Arrangements: Ofgem/DTI Conclusions Document" (October 1999), available on the Ofgem website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)).

The GSMG noted that the balance between directors with an 'industry perspective' and other directors was not formally commented on in the 1999 'Conclusions Document'.

## **4 ROLE OF THE BOARD**

### **4.1 Code Requirements**

Under the Code, the Board must fulfil the following requirements:

- Responsibility for the appointment of BSCCo Chief Executive (C4.6); and
- Responsibility for the approval of BSCCo's Annual Budget (C6.4).

### **4.2 Wider Role**

In addition to its specific requirements under the Code, the Board has the wider role of directing BSCCo. This role includes responsibility for monitoring of BSCCo's performance, scrutiny of BSCCo's finances and ensuring that BSCCo operations are subject to effective cost-control. The manner in which the Board fulfils this role is not set out in the Code, although certain requirements are included in BSCCo's Articles of Association. These include provisions relating to the appointment/retirement of directors, the appointment of alternative Directors and the delegation of power by the Board to Board committees. However, in general terms the way the Board conducts its business is not prescribed.

## **5 SAXTON BAMFYLDE HEVER REPORT**

In May 2003, Saxton Bamfylde Hever (SBH), an executive search and management assessment company<sup>3</sup>, was commissioned by the Board to review the management structure and reporting lines to enable BSCCo to better fulfil its BSC Obligations. SBH delivered a report, containing its findings and recommendations, to the Board in November 2003.

The SBH report contained a recommendation that BSCCo adopt a Board structure with both executive and non-executive membership. Specifically, that BSCCo's Chief Executive and another BSCCo executive holding an expanded, strategically and commercially orientated-role of 'Chief Financial Officer' would be added to the Board. The report concluded that this would improve the governance of BSCCo through (1) improving communications between executives and non-executives, (2) enabling the Executive to function better and (3) facilitating more effective non-executive challenge.

The SBH report was confidential to the Board. However, a set of extracts from the report, presenting SBH's recommended Board structure and the rationale for that structure, is attached as Annex 1 to this consultation document. In addition, a letter from SBH confirming that those extracts constitute an accurate representation of its views and recommendations is attached as Annex 2.

## **6 PROPOSED MODIFICATION: BOARD STRUCTURE**

### **6.1 Membership**

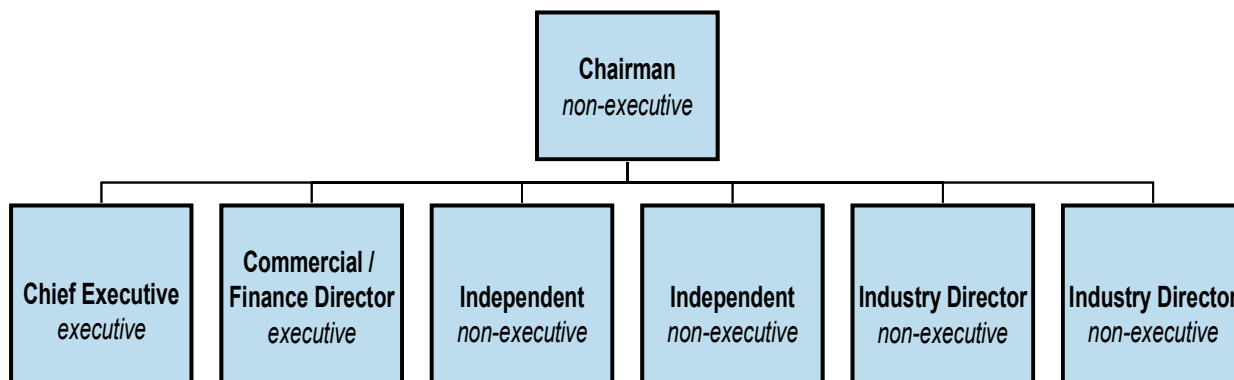
Under P161, two new Directors would be added to the Board - the BSCCo Chief Executive and a senior BSCCo executive, holding a commercially and financially orientated position.

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<sup>3</sup> For further details on SBH see [www.saxbam.com](http://www.saxbam.com).

The diagram B below provides an overview of the proposed Board structure and membership:

**Diagram B**



## 6.2 Rationale

The Proposer supports the conclusions of the Saxton Bamfylde Hever report on BSCCo's management structure. The review concluded that the present structure, which is prescribed by the Code, does not meet best practice in corporate governance. Furthermore, the Proposer endorses the specific recommendation namely that adding two 'executive director' positions to the Board would better facilitate the following:

- **Communication** between the Board and BSCCo's Executive team; and
- **Commercial challenge** (i.e. scrutiny of performance and costs by non-executive Directors).

According to the Proposer, a move to the proposed new Board structure would assist the company in addressing and responding to stakeholder concerns about the effectiveness of commercial drivers and cost control in BSCCo. In addition, a majority of non-executive members, and the associated advantages (i.e. independent scrutiny), would be retained, as would the expertise and perspective of two industry directors.

The Proposer believes that P161 would improve the efficiency of the administration of the trading arrangements (i.e. better facilitate achievement of Applicable BSC Objective (d)), through a reduction in the costs and an increase in the efficiency of BSCCo, and thereby enhance competition through a reduction in barriers to entry (i.e. better facilitate achievement of Applicable BSC Objective (c)).

## 7 PROPOSED MODIFICATION: EXECUTIVE DIRECTORS' CODE RIGHTS & OBLIGATIONS

The Code specifies certain rights of Directors (e.g. expenses, remuneration and indemnity) and prescribes their nomination and terms of office. P161, as submitted, specified that the proposed executive directors should have "the same rights and obligations as the Industry Directors and Other Directors" and that the senior BSCCo financial executive "shall be a person nominated and provided by BSCCo to the Board", (with the caveat that the Board consult with the Panel prior to appointment). The Proposer later clarified that the intention was that executive directors would have broadly the same

rights and obligations as Industry Directors<sup>4</sup>. However, the Proposer indicated that the detail of Executive Directors' rights, their nomination/appointment process and their terms of office should be developed during the Assessment Procedure.

The GSMG has established what the Code rights, nomination/appointment process and terms of Office for the proposed Executive Directors would be under the Proposed Modification. The table A below summarises the conclusions of the GSMG:

*Table A: Proposed Rights, Obligations & Processes for Executive Directors*

Right/Process	Nature	Rationale	Location
Expenses	Entitled to re-imbursement by BSCCo for "reasonable" costs and expenses incurred as a consequence of Board business	Identical to existing entitlement to expenses afforded to both "Industry Directors" and "Other Directors"	Existing Code provision would be used (i.e. C4.4.1)
Remuneration	Explicitly prohibited from additional remuneration for role as Director	Identical to existing prohibition on "Industry Directors" receiving remuneration for their services as Directors	Existing Code provision would be used (i.e. C4.4.3)
Nomination	Incumbents of BSCCo's Chief Executive role and BSCCo's most senior commercial and financial role would automatically be eligible for Directorship by virtue of their positions	Most transparent de facto method for realising P161 proposal of 'BSCCo nomination'	Added to Code
Voting Right	'One Member One Vote'	Consistent with existing provisions in BSCCo Articles of Association (AA) and current 'best practice' in corporate governance	Existing AA provisions would apply
Appointment	By Board resolution (with Panel consultation)	Consistent with existing provisions in BSCCo Articles of Association (AA) covering appointment of Directors	Existing AA provisions would apply
Term of Office	Concurrent with incumbency in BSCCo in relevant executive position	Logical and comparable to "Industry Director" terms of office (i.e. concurrent with Panel membership)	Added to Code
Removal	- by NGT as 'Shareholder'* - Disqualification (e.g. due mental disorder, bankruptcy etc...)	Consistent with existing provisions in BSCCo Articles of Association (AA) covering removal of Directors	Existing AA provisions would apply
Indemnity	Indemnified by BSCCo for all	Consistent with existing	Existing Code

<sup>4</sup> The rights of Industry Directors and Other Directors are not identical (e.g. remuneration).

	liabilities incurred in execution of role as a BSCCo Director	provisions in Code and BSCCo Articles of Association (AA) for existing Directors	(C4.5.1) and AA provisions would apply
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The GSMG would welcome views on the rights and processes proposed for Executive Directors.

## **8 INITIAL ASSESSMENT OF PROPOSED MODIFICATION**

This section provides the GSMG's initial assessment of the issues included in the Assessment Procedure Terms of Reference by the Panel.

### **8.1 Case for Executive Directors on the Board**

The GSMG discussed the case for including BSCCo executives on the Board, noting the potential advantages and disadvantages.

#### **8.1.1 Rationale for Existing Non-Executive Board**

The GSMG noted the rationale for an entirely non-executive Board membership reported in the SBH report (see Annex 1). First, to ensure that BSCCo operated as a responsive and essentially administrative organisation, rather one pursuing its own agenda. Second, to ensure that BSCCo remained under non-executive control and accountable to stakeholders, by militating against the possibility that the Board, and hence BSCCo's policies, might be 'captured' by the ambitions of the executive.

#### **8.1.2 Potential Advantages of Executive Directors**

The GSMG noted the benefits that the Proposer believes the addition of executive directors to the Board would have. First, communication between the BSCCo executive team and the Board would be enhanced (i.e. by adding BSCCo executives to the Board). Second, scrutiny of BSCCo's costs and performance would be better facilitated (i.e. by adding a BSCCo executive holding a financial role to the Board).

The GSMG noted the ELEXON view that adding executives to the Board would facilitate more efficient communication between those responsible for implementing company policy (i.e. the BSCCo Executive team) and those responsible for setting policy (i.e. Board members). In addition, executive directors would bring an operational perspective and knowledge to Board discussions that might enhance the ability of non-executive directors to scrutinise the management of BSCCo. In particular, non-executive directors could be significantly more empowered, through a better appreciation of how the business is being run, to challenge the plans, performance and costs of BSCCo.

The GSMG noted that executive directors would participate by right in decision making by the Board, including voting, and noted the ELEXON view that this inclusion of the executive perspective should benefit the decision making process.

The GSMG also noted that, even were P161 implemented, the Board would retain a majority of non-executive directors.

Finally, the GSMG noted the benefits of adding executive directors presented in the SBH report (see Annex 1). In summary, these are as follows:

- Reduction of 'distance' between executives and non-executive directors;
- Enable BSCCo to function more effectively at the executive level;
- Facilitate succession planning within BSCCo;
- Enable Board's to set BSCCo's strategy based on 'rich information' about the organisation; and
- Enable more effective 'non-executive' challenge of BSCCo.

Having noted the potential advantages of executive directors, the GSMG questioned whether addressing the issues raised by P161 (i.e. communication and scrutiny) required a change to the current Board structure and membership.

### **8.1.3 Attendees versus Directors**

The GSMG agreed that a key issue was what, if any, additional advantage would be realised through having executive directors on the Board as opposed to executive attendees at Board meetings.

Under law, directors have a statutory and common law duty to act in the best interests of the company as a whole and may incur personal liability, both civil and criminal, for any acts or omissions in directing a company and for breach of statutory duty<sup>5</sup>. The GSMG noted the ELEXON view that executive directors might be best placed to bring operational issues to the attention of a board and challenge policy that they believe could adversely affect the interests of the company. Executives attending a board can and probably endeavour to act in such a manner. However, a statutory obligation and common law to do so perhaps results in a more robust governance model than reliance on the good intentions of current or future executives. Therefore, it could be argued that the inclusion of executive directors on the Board would improve the scrutiny of BSCCo's policy and strategy.

However, the GSMG noted that it could be argued that attendance at the Board by well informed executives acting in the best interests of BSCCo should be sufficient to ensure that (1) efficient communication between the Board and the Executive and (2) scrutiny of company performance and plans takes place. Moreover, alternatives may exist, through improvement of current working practices for example, to address any perceived deficiencies within the existing Board structure.

The GSMG noted that the Board has passed a resolution requiring the CEO and 'Chief Financial Officer' (CFO) to attend Board meetings, allowing them to participate fully (short of voting). It was further noted that other members of the ELEXON executive team had a 'standing invitation' to attend Board meetings.

Several members of the GSMG expressed a concern that a "conflict of role" may exist for executive directors who are charged with both presenting the case for a policy or plan (e.g. a budget) and challenging and scrutinising it. One GSMG member, in support of this concern, quoted from the Higgs Report on non-executive directors:

*"There is natural potential for conflict between the interests of executive management and shareholders in the case of director remuneration, or audit (where decisions on the financial*

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<sup>5</sup> There is no legal distinction between 'executive' and 'non-executive' directors.

*results can have a direct impact on remuneration), or indeed in a range of other instances. Although there is a legal duty on all directors to act in the best interests of the company, it has long been recognised that in itself this is insufficient to give full assurance that these potential conflicts will not impair objective board decision-making.<sup>6</sup>*

A counter-argument to this concern was expressed by ELEXON – unlike executive attendees, executive directors have a statutory duty to scrutinise, and challenge where deemed appropriate, any company plan or policy (regardless of any past or ongoing involvement in it).

The GSMG acknowledged that any such conflict between the role of manager and director would appear to arise for any executive director of any company, although in many cases it would be balanced by more direct accountability than existed for BSCCo.

The GSMG also discussed attendance versus directorship in terms of the accountability of BSCCo to its stakeholders. On the one hand, it was considered that placing the statutory duties of directorship on BSCCo executives could be considered to increase that accountability. BSCCo could be held more accountable to its stakeholders if members of its management had a legal duty of care, by virtue of being directors, towards the company's interests. A duty for whose breach these managers were liable under law. On the other hand, some members of the GSMG were of the opinion that an executive's accountability for his or her actions in implementing company policy derives primarily from a contract of employment and that the statutory duties of directorship would not appreciably increase that accountability.

In short, the GSMG noted that attendance by executives at the Board would appear to bring many of the benefits of increased communication which the Proposal sought. However, the GSMG noted ELEXON's concern that it would not bring the final incentive for such communication that the legal obligations on a director provided.

Attendees at the Board would, in the end, be providers of information to the decision making process, whilst directors would be a full part of it by right up to and including voting.

## **8.2 Case for Proposed Executive Directors**

The GSMG considered whether the Code ought to be specific that, in addition to the Chief Executive, a BSCCo executive holding a commercially and financially orientated position should be added to the Board. In contrast, for example, would it be more appropriate to allow discretion (by the Chairman of the Board) over which BSCCo executive filled the second executive director position on the Board?

The GSMG concluded that, given the form of the Modification Proposal, an executive holding a commercially or financially orientated role should fill the second executive director position. This was felt to be essential to realise the benefit of an enhanced emphasis on and effectiveness in Board scrutiny of operations, budgets and costs. The GSMG noted that the defect identified by P161 was specific – BSCCo's Board does not fit best practice in corporate governance because it does not include the Chief Executive and a senior executive with a commercially or financially orientated role.

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<sup>6</sup> See paragraphs 9.2 and 9.3 of the "Review of the Role and Effectiveness of non-Executive Directors" (Derek Higgs, January 2003), which is available at [http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/higgsreport.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf).

### **8.3 Balance of Proposed Board Structure**

The GSMG considered the balance between the different categories of directors that would result from the proposed Board structure and the implications of that balance. In particular, the GSMG considered that the balance between Industry Directors and the other categories of Directors was potentially significant.

The GSMG acknowledged that each category of director (i.e. proposed executive directors, 'Industry Directors' and 'Other Directors'), and present and future incumbents in each of those categories, brought and would bring a unique perspective, experience and expertise.

The GSMG noted that Directors were obliged to act in the best interests of the company, and were not appointed to represent sector interests. Nonetheless, members of the GSMG emphasised that Industry Directors brought a particular perspective to their consideration of BSCCo matters.

The GSMG noted that a potential advantage of adding executive directors to the board would be the operational experience and perspective that such directors could contribute to Board discussions which, when coupled with the statutory duties of directorship, might broaden the perspective of the Board and deepen scrutiny of the company. However, some GSMG members considered that ensuring that an operational perspective was included in Board discussions could equally be achieved by requiring that the relevant BSCCo executives to attend Board meetings.

Members of the GSMG saw that a possible disadvantage of adding executive directors would be that the influence of the industry perspective on company policy and operations (from the views of the two Industry Directors) would be diminished. Under P161, there would be 2 Industry Directors out of 7 directors, rather than by 2 out of 5 as at present. However, as a counter-argument, it was noted that all directors have a statutory duty to consider the company's best interests, and by extension what is most conducive to efficient Balancing and Settlement arrangements (i.e. the purpose of BSCCo). It was further noted that non-executive directors would still be in a majority.

### **8.4 Appropriateness of Proposed Structure for Non-Profit Organisation**

The GSMG considered whether or not the proposed Board structure (i.e. one with executive directors) would be appropriate for non-profit organisations such as BSCCo.

The GSMG noted that the SBH reported that many non-profit organisations are now moving away from wholly non-executive boards, quoting Ofgem, the FSA, the Office for Fair Trading and the DTI as examples (see Annex 1). In addition, the GSMG also noted that while the Higgs report focused on the corporate governance of listed companies, the Author indicated that he hoped his recommendations would be of wider interest and use:

*"In the Review, I have consciously focused on corporate governance arrangements in the UK listed sector, since it is to those companies that the Code applies. I recognise that a number of my recommendations may also be relevant to other companies and organisations and I hope that the Review will therefore be of wider interest and use."*<sup>7</sup>

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<sup>7</sup> See paragraph 1.22 of the "Review of the Role and Effectiveness of non-Executive Directors" (Derek Higgs, January 2003), which is available at [http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/higgsreport.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf)

The GSMG considered that what was most relevant was not so much if there were evidence of other non-profit organisations with 'mixed boards' (i.e. boards comprising both executive and non-executive directors), but evidence of comparable organisations (i.e. other not-for-profit electricity market operators) with such governance. However, the GSMG recognised that the boards of such companies would reflect the role of those companies and the governance arrangements within which they operated. As such, a like-for-like comparison would probably not be possible.

For example, in Australia, the National Electricity Market Management Company (NEMMCo) performs the dual role of 'market operator'<sup>8</sup> and 'system operator'<sup>9</sup> on a not-for-profit basis. NEMMCo's board comprises six non-executive directors and one executive director (NEMMCo's Chief Executive Officer). However, the nature of the non-executive membership represents the specific constitution of the Australian market. Each of the six non-executive directors represents one of the six jurisdictions forming the National Electricity Market (NEM) – Queensland, Victoria, New South Wales, South Australian, the Australian Capital Territory and the State of Tasmania.

The GSMG noted that other companies, such as M-co (the market operator in New Zealand) and PJM (a regional market operator/system operator in the USA), were not deemed relevant given that they operated on a commercial basis.

Finally, the GSMG noted that a strong executive presence on the Board is often seen as good practice (for example, in the Combined Code on Corporate Governance<sup>10</sup>). However, the GSMG noted that BSCCo's particular circumstances as a non-profit organisation, without direct accountability to shareholders, should be taken into account in considering the applicability of "good practice".

## 8.5 Initial Conclusions

After its initial assessment, the majority of the GSMG remained to be convinced that the Proposed Modification would better facilitate achievement of the Applicable BSC Objectives. There was concern that P161 would introduce a potential conflict of roles (i.e. between executive directors' dual roles as BSCCo executives and BSCCo directors) into Board business and that it would dilute the influence of the industry perspective in Board business.

In addition, the majority of the GSMG believed there might be the potential to address any perceived deficiencies in (1) communication between the BSCCo Board and the BSCCo Executive and (2) non-executive scrutiny within the existing Board structure. For example, the GSMG noted that, as working practice, both the Chief Executive and the senior financial executive within BSCCo were now required to attend all Board meetings.

## 9 POTENTIAL ALTERNATIVE MODIFICATIONS

The GSMG identified four potential Alternative Modifications, each of which, to varying degrees, it considered might go some way to addressing two of its principal concerns (1) potential conflict of roles

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<sup>8</sup> The 'market operator' role comprises responsibility for the management of the 'spot market' (i.e. matching of 'bids' and 'offers' to ensure a balance between supply and demand) and the management of the 'electricity pool' (i.e. central dispatch).

<sup>9</sup> The 'system operator' role comprises responsibility for the management and maintenance of the technical operating standards of the power system.

<sup>10</sup> The Combined Code on Corporate Governance, produced by the Financial Reporting Council, is based on Derek Higgs' January 2003 report on non-executive directors and Sir Robert Smith's January 2003 report on audit committees. The Code came into effect in November 2003, and is available on the website of the European Corporate Governance Institute at [http://www.ecgi.org/codes/country\\_documents/uk/combined\\_code\\_final.pdf](http://www.ecgi.org/codes/country_documents/uk/combined_code_final.pdf).

for executive directors and (2) potential dilution of the industry perspective. The majority of the GSMG believed that all four options were preferable to the Proposed Modification.

Note that each of the four potential Alternative Modifications would be an extension to the Proposed Modification – i.e. Proposed Modification as submitted plus additional provisions. The following subsections provide a description of each potential Alternative Modification and the GSMG's conclusions on each.

### **9.1 Option 1: Restricted Voting Rights for Executive Directors**

Under this option, the two executive directors would be prohibited from voting on the Annual Budget, but would be entitled to vote on all other Board business.

The GSMG believes that such a restriction would remove the potential conflict of roles for executive directors in the area in which it would be most likely to arise and address the concern that the industry perspective would be diluted in the important area of the Annual Budget, whilst still realising the purported benefits of the Proposed Modification. Executive directors, through being able to vote on Board business aside the Annual Budget, would still be empowered sufficiently such that communication and scrutiny would be enhanced.

The GSMG noted the advice received from ELEXON that this option raised no legal issues. However, the GSMG questioned whether protection for executive directors from potential liabilities arising from Board decisions on the Annual Budget would be required.

The majority of the GSMG considered this option to be superior to the Proposed Modification.

### **9.2 Option 2: Weighted Voting Rights for Industry Directors**

Under this option, the two existing Industry Directors' votes would be more heavily weighted than the votes of the other categories of Director. Each Industry Director would have two votes (i.e. each individual's vote would be weighted by a factor of two).

The GSMG believes that this option would address the concern that the industry perspective on Board business would be diluted whilst retaining the purported benefits of the Proposed Modification (i.e. enhanced communication and scrutiny). In addition, the GSMG noted that weighted voting was an existing (though relatively unusual) practice in corporate governance.

The GSMG discussed two concerns with this option. First, what justification was there for weighting the 'industry perspective' and the individual perspectives of the incumbent Industry Directors? Second, the perspective of other non-executive directors would be diluted.

The majority of the GSMG considered this option to be superior to the Proposed Modification.

### **9.3 Option 3: Additional Industry Directors**

Under this option, additional 'Industry Directors' would be added to the Board.

The GSMG believes that this option would address the concern that the industry perspective on Board business would be diluted whilst retaining the purported benefits of the Proposed Modification (i.e. enhanced communication and scrutiny). In addition, this option would not rely on either the restriction

of or giving more weight to the votes of category of directors and the individual incumbent within those categories.

However, the GSMG identified several practical concerns with this option. First, the cost of the Board could increase on account of additional expenses being incurred and claimed (although these were not considered to a material issue). Second, were a large number of additional Industry Directors added to the Board, the efficiency of the Board might be reduced. However, the GSMG did not believe that this would be a material issue were just one or two additional Industry Directors added to the Board. Finally, and most significantly, there is only a limited pool of industry representatives on the Panel, and requiring more than two of those representatives to be directors could be difficult. This suggested that a further nomination process might need to be added to the BSC were this option developed further.

The majority of the GSMG considered this option to be superior to the Proposed Modification.

#### **9.4 Option 4: No Voting Rights for Executive Directors**

Under this option, the two executive directors would not be entitled to vote on any Board business.

The GSMG believes that such a restriction would remove the potential conflict of roles for executive directors and address the concern that the industry perspective on Board business would be diluted. However, the GSMG questioned whether or not, under this option, the executive directors would be sufficiently empowered for the purported benefits of the Proposed Modification, enhanced communication and scrutiny to be realised. In addition, the GSMG noted the legal advice received from ELEXON. The advice indicated that this option appeared to be at variance with the fundamental concept of a director, and, indeed, the arrangement might be considered improper – the two executive directors would have the legal duties of directorship without the voting rights that allow them to discharge those duties.

This raised the practical consideration that it might be difficult to find candidates to fill these roles.

ELEXON indicated that, whilst no legal restrictions on prohibiting executive directors from voting had yet been found, were this option to be progressed further legal counsel would need to be sought.

The GSMG concluded that this option should not be progressed further on account of its questionable benefits and potential legal complications.

## **ANNEX 1 EXTRACTS FROM SAXTON BAMFYLD HEVER REPORT**

### **EXECUTIVE SUMMARY**

This report recommends that ELEXON should move, if possible, to a board structure with mixed executive and non-executive membership. Reasons for making this change are presented. Approached correctly, such a change would reduce the distance between executives and non-executives and should enable ELEXON not only to function more effectively at executive level but also to be subject to more effective non-executive challenge. After consideration of a range of options, this report notes that structures with 2, 3 or 4 executive members of the board would all be feasible, but with different patterns of advantage and disadvantage to each.

The best fit to ELEXON's present needs would on balance be achieved by adding two executive positions to the board – that of chief executive and an expanded, strategic and commercially-oriented role of chief financial officer – and creating a small number of associate director positions. The report defines key features of the associate director role including attendance at most board meetings, and the right and responsibility to contribute to the board's discussion across all subjects; but not in formal terms a vote.

There are clear connections between the questions of creating executive or associate directors and the wider structuring of the senior management team below the board; however it is equally important to note the chief executive's prerogative in the latter area. At the chief executive's invitation, the report goes on to recommend for consideration changes which would affect or re-allocate the responsibilities of 3 head of department posts (strategic commercial services, assurance and corporate affairs); as well as some other changes. The report recommends creating three associate director positions, with responsibility in line management terms for service delivery, change delivery and (an expanded role) stakeholder assurance.

For a fuller statement of the report's proposed structure and summary of the reasons for it, without needing to review all other variations considered, the reader is referred to the section 'Recommended Structure' on page XX and the final diagram on page YY.

The legal feasibility of making such changes is outside the scope of this report. Consideration of what is possible here may also affect how best to avoid a period of 'planning blight' within the organisation while it waits for formal legal changes (eg Code Modifications) to be approved. The report's suggested approach is, after preparatory consultation, to implement the new structure straight away although technically in 'shadow' form, pending legal procedures. Training and development for the new board is an important opportunity to grasp, in order for the full benefit of any new structure to be achieved.

### **LEGAL CONSTRAINTS AND TRANSITION**

We have been asked to undertake this review on the assumption that legal means can be found which, subject to approval of any necessary Code Modifications, would give effect to a mixed executive and non-executive membership of the board. If in fact this did not prove legally possible, then we would recommend the board nevertheless to devise and implement the closest, legally viable, approximation to the desired structure. This would be a matter for legal advice but could, for example, include creating a new nomenclature for the relevant posts and passing standing orders regarding the authority delegated to those posts, and attendance and participation at board meetings.

Devising such a 'shadow' structure is also worth consideration from the point of view of an effective transition from the present structure to any new one. If the board decided after due consideration, possibly including soundings with a range of stakeholders, that a new board structure with mixed membership was the right structure to lead ELEXON forward and that the new structure would be likely to command the confidence of stakeholders, then it would be unwise to pitch the leadership of ELEXON into a 'planning blight' phase possibly of some months while Code Modifications or other measures were considered and approved. If legally feasible, we suggest it would be better to move immediately on announcement day (or very shortly thereafter) to the recommended structure but in shadow form.

Saxton Bampfylde Hever highly recommend the use of board development training that would aid the board in operating at its full potential. There are many excellent speciality resources and we would be pleased to offer suggestions. Saxton Bampfylde Hever has no commercial relationship with organisations offering these services.

**ANALYSIS OF ADDING NO MEMBERS  
OF THE SENIOR MANAGEMENT GROUP TO THE BOARD (IE NO CHANGE)**

**Popularity**

- This option was not suggested by any member of the senior management group.

**Advantages**

- No modification to the Code required
- Streamlined decision making

**Disadvantages**

- Board has less information and therefore may focus on the wrong issues
- Executives may feel disconnected from the decisions taken by the board
- Narrow communication channels inhibit information flow to executives
- Inhibits succession planning in the executive team
- Not a structure that is widely used in the commercial world or in keeping with the ELEXON value statement 'commercial in thought and deed'

**Recommendation**

Adding no members of the senior management group is not recommended by Saxton Bampfylde Hever. It has been explained to Saxton Bampfylde Hever that the reasons for creating ELEXON with its present, wholly non-executive, board composition were:

1. to reflect ELEXON's non-profit mission;
2. to ensure that ELEXON – whose activities are not subject to a competitive market check, and are paid for by analogy to an industry 'tax' – would not be 'captured' by the natural ambitions of its executive team but remain subject to clear non-executive control and stakeholder accountability; and

3. to reflect that ELEXON did not create its own future agenda but responded, as a service function, to changes demanded by others and agreed through an appropriate external mechanism. (Arguably this suggests a picture of ELEXON as a quasi-administrative, secretariat-style organisation, and these sometimes have wholly non-executive boards.)

If these were the considerations, in Saxton Bampfylde Hever's assessment of the present situation, they are misdirected or misconceived. Taking the points in turn:

1. The main category of non-profit body in the UK which has a wholly non-executive board is the registered charity, which typically has unpaid trustees with no paid executives as part of the trustee body (which legally constitutes and directs the charity). However, there is currently a strong and publicly expressed desire on the part of the UK charity sector for amended legislation to allow mixed executive and non-executive boards, precisely because of the difficulties in running complex operations which a wholly non-executive board structure imposes. In addition, many non-profit bodies have either avoided, or moved away from, the wholly non-executive board. For example Ofgem itself, in common with most UK regulatory bodies, has moved in recent years to a mixed board (the Office of Fair Trading and the Financial Services Authority also provide examples of non-profit bodies run by mixed boards). Even essentially administrative organisations such as central government departments (like the DTI), many of which have set up boards of one kind or another in recent years, have by large majority opted for mixed boards.
2. Expectations for what boards can and should achieve are changing; as a consequence of the publication of various reports, most recently Higgs, and the resulting changes to company listing and accounting requirements, the standards of commercial governance have been raised. The Higgs Report acknowledges that non-executives should act as a very clear check and balance to the ambitions of executive teams.
3. ELEXON's operations are in fact complex and require corporate leadership of significant calibre. Even if ELEXON had not set itself the goal of being 'commercial in thought and deed', a well-managed ELEXON would need to be much more than a backwater administrative/secretariat operation. ELEXON's operations suffer, and stakeholders lose some value, because of the present board structure. For example this is corroborated by the current (and entirely independently conducted) culture survey which suggests that the board needs to act much more like a normal board, less distant from the senior team, and that board scrutiny of budgets and costs could be more effective. A significant feature of all the board membership options which we recommend is an enhanced role of Chief Financial Officer on the board, which should help in this respect.

In summary we consider that it is hard to set effectively the strategy for an organisation of ELEXON's complexity, and judge the adequacy of delivery, without very rich information about the organisation. Bringing members of the senior management group on to the board brings this richness of information and this aids non-executives to ask pertinent questions. It is our view that given that ELEXON Ltd currently has no executives on the board there is some considerable scope to bring on to the board members of the senior management group without compromising the authority of the non-executives.

Finally, we believe that an organisation with functions of the complexity and uniqueness of ELEXON should, as part of contingency planning for chief executive succession, have concerns about the inhibition which the present structure places on developing strong potential internal successors. (Note the plural in 'successors' – this point is not about anointing one heir apparent. Nor do we overlook the likelihood, as it seems to us, that an organisation like ELEXON should consider external candidates when filling a chief executive vacancy.)

## **RECOMMENDED STRUCTURE**

This section draws together the consideration of structures at the board and just below it to restate the option which Saxton Bampfylde Hever consider represents the best way forward for ELEXON, and the benefits appropriate to the purpose of this review which will flow, if the recommended changes are made with the support of appropriate training and board development, with prior informal soundings with critical external stakeholders and with commitment to implement the new structure speedily in shadow form.

The benefits which flow from making any changes should be of three kinds.

- Enhanced board governance is an objective for any review of board functioning: in particular more effective strategic direction-setting and challenge, accountability to stakeholders/shareholders, and clear responsibilities and good communication between the board and the executive team.
- Benefits contributing to ELEXON's Core Values, restated in the scope of this review. Creativity, productivity, commerciality, continuous improvement and fairness for staff deserve particular mention in this context.
- Specific matters identified in the objectives of the review: faster, better decision-making with reduced costs and enhancement of internal succession planning for the chief executive role. (Improved internal succession planning in no way excludes the option of vigorous external competition at the future point when succession needs to occur.)

The recommended structure provides strong enhancements in all three areas, and has been reached after wide-ranging consideration of other variations and possibilities.

- (1) It is recommended that the board of ELEXON should be expanded to incorporate two full executive members, the chief executive officer (CEO) and the chief financial officer (CFO).
- (2) The CFO role is proactive, strategic and commercial, and includes the central corporate responsibility for contracts and procurement (currently part of strategic commercial services) and for internal assurance including the balanced scorecard (currently part of assurance).
- (3) Three associate director positions are created reporting to the CEO. The nature of associate director responsibility has been set out in detail but in shorthand they are virtually director roles, but without voting power. These roles are service delivery, change delivery and stakeholder assurance (the latter is a working title and combines the present stakeholder services role with the external assurance elements of assurance).
- (4) The human resources (HR) and legal functions should report to the CEO. Property and internal information technology may report to the CFO or CEO.
- (5) The present roles of head of commercial services, head of assurance and head of corporate affairs come to an end.

The governance benefits of this structure are significant. A strong majority of non-executive members (5) to voting executive members (2) is maintained, using a model which – particularly through the enhanced CFO role – strengthens the ability of the non-executives to challenge plans, performance, costs and risk. The model proposed derives from common commercial practice and is consistent with relevant non-profit board models (eg Ofgem). The present governance arrangements do not fit any best practice model, are uncommercial, constrict communication and understanding between the board and the executive team and – for example on the evidence of the recent culture survey – are contributing to weaknesses in challenging both performance and costs.

In terms of ELEXON's values the proposed structure is recognisably commercial. Improved communication between executives and non-executives, with more frequent and wide-ranging contact on matters of strategic rather than departmental importance, will stimulate the executive team to think more widely and innovatively in the interests of stakeholders as a whole, and give non-executives greater confidence to back innovative proposals when the executives bring them forward. This greater contact and wider responsibility is also fair to staff, since the present structure provides them with restricted opportunity to demonstrate director capabilities, and since training and board development are an integral part of these proposals.

In terms of speed and cost, these proposals streamline the senior executive team in a substantial way. The present structure has delivered benefits, and where these are important to retain in the future (for example the separation of service delivery from change delivery or the separation of assurance from delivery) these features are kept in the new structure. But compared to future needs the present structure has too many roles, which costs time and money. Within a streamlined structure, the enhanced CFO role should contribute to future benefits in commerciality, speed and cost.

In terms of succession planning, the present structure is a significant risk for ELEXON. ELEXON has intricate operations and relationships of vital industry importance which are relatively unusual. While an external competition is likely to be sensible to fill any chief executive vacancy, the present arrangements – with no executives on the board and executives mainly functioning in head of department roles - put ELEXON at risk in two ways. When an external competition comes, the quality of the internal field will not be as strong as it should be. And in the meantime, executives who wish to develop their careers may feel they need to leave in order to do so, taking knowledge with them which may actually make it harder for the board to fill the CEO role externally. The proposed structure addresses these weaknesses without falling into the alternative trap of the single 'heir apparent'.

**ANNEX 2 SAXTON BAMFYLDE HEVER LETTER CERTIFYING EXTRACTS**

London, 1 March 2004  
Mr Brian Saunders  
ELEXON Ltd  
350 Euston Road  
LONDON NW1 3AW

Dear Brian

**MODIFICATION TO ELEXON'S BOARD STRUCTURE**

Thank you for your letter of 26 February. The extracts from our report which you enclosed are a fair picture for your purpose and we have no difficulty in your circulating them to the Modification Group.

In particular they highlight that, in our view, the changes proposed will strengthen rather than dilute the ability of the non-executive directors to hold the executive to account. There is no point in repeating here all the points made in the report extracts, but I would highlight that:

- i. our recommendation is not to add to the board the chief executive plus one other executive of his/her choice; it is to add the chief executive and (what we called in the report) an upgraded chief financial officer role. CFOs – especially if they have the obligations of being full directors – have a widely recognised part to play in helping the whole board understand risks, enforce controls, challenge costs and consider alternatives to proposed strategies. The skills, the information and the professional obligations which a CFO brings to the board table should all strengthen the board's capacity to challenge;
- ii. the consequences of attempting this with a structure in which the CFO is not made a member of the board will include some mixture of the following: that individual will not have the legal obligations of a director; their clout within the executive team will be reduced; their duty in certain situations to enable non-executives to understand issues which might lead them to challenge the chief executive is removed; and the calibre of individual prepared to undertake the role would go down.

To try to have one's cake and eat it – ie to give the CFO the duties and responsibilities of being a director without actually making them a director – would, I imagine, create issues around 'shadow directors' which must be for legal advice. But from a recruitment point of view, especially in today's governance climate, it is hard to see any finance professional of appropriate calibre knowingly taking on these risks without the clout which should go with them.

Please let me know if we can help in any other way.

With best wishes

Yours

**Douglas Board**