

## ASSESSMENT REPORT for Modification Proposal P161 Enhancement of BSCCo Board Structure

Prepared by: Governance Standing Modification Group

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This document has been distributed in accordance with Section F2.1.10<sup>1</sup> of the Balancing and Settlement Code.

### RECOMMENDATIONS

The Governance Standing Modification Group (GSMG) invites the Panel to;

- **Having considered and taken into due account the contents of the P161 Assessment Report, AGREE that the Proposed Modification P161 should not be made;**
- **AGREE an Implementation Date for Proposed Modification P161 of 30 Working Days after an Authority decision in the event that the Authority determines that the Proposed Modification P161 should be made;**
- **AGREE that Modification Proposal P161 be submitted to the Report Phase; and**
- **AGREE that the draft Modification Report be issued for consultation and submitted to the Panel Meeting of 13 May 2004.**

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<sup>1</sup> The current version of the Balancing and Settlement Code (the 'Code') can be found at [www.elexon.co.uk/ta/bscres\\_docs/bsc\\_code.html](http://www.elexon.co.uk/ta/bscres_docs/bsc_code.html)

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## SUMMARY OF IMPACTED PARTIES AND DOCUMENTS

As far as the GSMG has been able to assess the following parties/documents have been identified as being potentially impacted by Modification Proposal P161:

Parties	Sections of the BSC	Code Subsidiary Documents
Suppliers <input type="checkbox"/>	A <input type="checkbox"/>	BSC Procedures <input type="checkbox"/>
Generators <input type="checkbox"/>	B <input type="checkbox"/>	Codes of Practice <input type="checkbox"/>
Licence Exemptable Generators <input type="checkbox"/>	C <input checked="" type="checkbox"/>	BSC Service Descriptions <input type="checkbox"/>
Transmission Company <input type="checkbox"/>	D <input type="checkbox"/>	Service Lines <input type="checkbox"/>
Interconnector <input type="checkbox"/>	E <input type="checkbox"/>	Data Catalogues <input type="checkbox"/>
Distribution System Operators <input type="checkbox"/>	F <input type="checkbox"/>	Communication Requirements Documents <input type="checkbox"/>
<b>Party Agents</b>		
Data Aggregators <input type="checkbox"/>	G <input type="checkbox"/>	Reporting Catalogue <input type="checkbox"/>
Data Collectors <input type="checkbox"/>	H <input type="checkbox"/>	MIDS <input type="checkbox"/>
Meter Operator Agents <input type="checkbox"/>	J <input type="checkbox"/>	<b>Core Industry Documents</b>
ECVNA <input type="checkbox"/>	K <input type="checkbox"/>	Grid Code <input type="checkbox"/>
MVRNA <input type="checkbox"/>	L <input type="checkbox"/>	Supplemental Agreements <input type="checkbox"/>
<b>BSC Agents</b>		
SAA <input type="checkbox"/>	M <input type="checkbox"/>	Ancillary Services Agreements <input type="checkbox"/>
FAA <input type="checkbox"/>	N <input type="checkbox"/>	Master Registration Agreement <input type="checkbox"/>
BMRA <input type="checkbox"/>	O <input type="checkbox"/>	Data Transfer Services Agreement <input type="checkbox"/>
ECVAA <input type="checkbox"/>	P <input type="checkbox"/>	British Grid Systems Agreement <input type="checkbox"/>
CDCA <input type="checkbox"/>	Q <input type="checkbox"/>	Use of Interconnector Agreement <input type="checkbox"/>
TAA <input type="checkbox"/>	R <input type="checkbox"/>	Settlement Agreement for Scotland <input type="checkbox"/>
CRA <input type="checkbox"/>	S <input type="checkbox"/>	Distribution Codes <input type="checkbox"/>
Teleswitch Agent <input type="checkbox"/>	T <input type="checkbox"/>	Distribution Use of System Agreements <input type="checkbox"/>
SVAA <input type="checkbox"/>	U <input type="checkbox"/>	Distribution Connection Agreements <input type="checkbox"/>
BSC Auditor <input type="checkbox"/>	V <input type="checkbox"/>	<b>BSCCo</b>
Profile Administrator <input type="checkbox"/>	W <input type="checkbox"/>	Internal Working Procedures <input checked="" type="checkbox"/>
Certification Agent <input type="checkbox"/>	X <input checked="" type="checkbox"/>	<b>Other Documents</b>
MIDP <input type="checkbox"/>		Transmission Licence <input type="checkbox"/>
TLFA <input type="checkbox"/>		
<b>Other Agents</b>		
SMRA <input type="checkbox"/>		
Data Transmission Provider <input type="checkbox"/>		

X = Identified in Report for last Procedure  
 N = Newly identified in this Report

# **1 DESCRIPTION OF PROPOSED MODIFICATION AND ASSESSMENT AGAINST THE APPLICABLE BSC OBJECTIVES**

## **1.1 Modification Proposal**

Modification Proposal P161 "Enhancement of BSCCo Board Structure" (P161) (Reference 1) 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 (Reference 2) 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 GSMG was assigned to carry out the Assessment Procedure<sup>2</sup>.

The GSMG met three times to carry out the Assessment Procedure, on 19 February 2004, 2 March 2004 and 24 March 2004. In addition, a consultation exercise was undertaken. A consultation document (Reference 3) was issued on 10 March 2004, with a deadline for responses of 19 March 2004. Eleven responses (52 Parties) were received. The responses are attached as Annex 3 of this report and summarised in Section 6.

## **1.2 Background to Modification Proposal**

### **1.2.1 Current Board Structure**

#### **1.2.1.1 Membership**

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

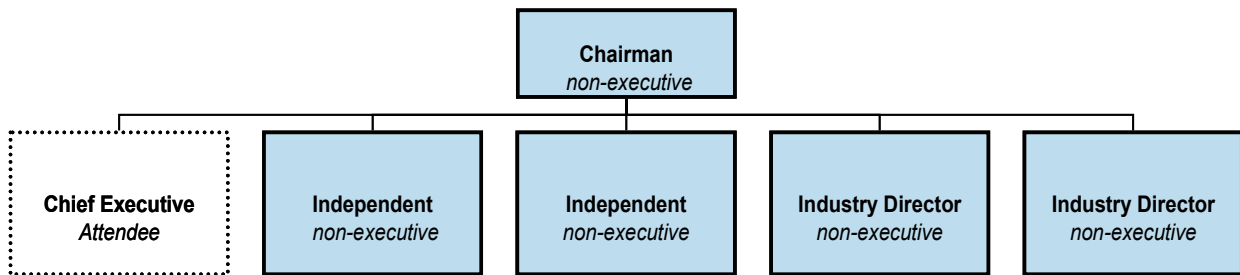
- Chairman of the Board (who shall also be the Panel Chairman);
- 2 Industry Directors (Industry Panel members nominated by the Panel); and
- 2 Other Directors (persons nominated by the Panel Chairman after consultation with the Panel).

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).

Diagram A overleaf provides an overview of the current Board structure and membership:

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<sup>2</sup> The Panel made several additions to the standard Assessment Procedure Terms of Reference (see Annex 2)

**Diagram A**

### 1.2.1.2 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 was that the Panel would act as and perform the role of the BSCCo Board (Reference 4)<sup>3</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>4</sup>

The GSMG noted that the Ofgem/DTI conclusions, as represented by the 1999 'Conclusions Document' (Reference 5), suggested that three 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>3</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>4</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'.

## **1.2.2 Role of Board**

### **1.2.2.1 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).

### **1.2.2.2 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.

## **1.2.3 Saxton Bamfylde Hever Report**

In May 2003, Saxton Bamfylde Hever (SBH), an executive search and management assessment company<sup>5</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 BSCCo executive to function better and (3) facilitating more effective non-executive challenge.

The SBH report was confidential to the Board. However, a comprehensive set of extracts from the report, presenting SBH's recommended Board structure and the rationale for that structure, is attached as Annex 6 of this report. In addition, a letter from SBH confirming that those extracts constitute an accurate representation of its views and recommendations is attached as Annex 7.

The GSMG noted that "ELEXON's Business Strategy and Annual Budget 1 April 2004 – 31 March 2007"<sup>6</sup> (Reference 6) contains the following comment:

*"The restructuring of the Board to include the two proposed new directors requires a Modification to the BSC, which is being instigated through a Modification Proposal. It is considered that such a Modification is desirable to both the industry and Ofgem."*

As a consequence, the GSMG assumed that the Board had endorsed the recommendations of the SBH report on the Board.

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<sup>5</sup> For further details on SBH see [www.saxbam.com](http://www.saxbam.com).

<sup>6</sup> P.19

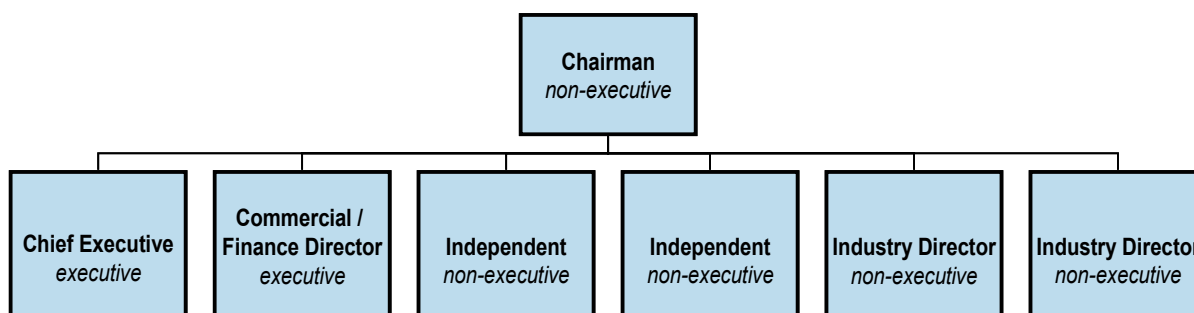
## 1.2.4 Proposed Board Structure

### 1.2.4.1 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.

Diagram B (below) provides an overview of the proposed Board structure and membership:

**Diagram B**



### 1.2.4.2 Rationale

The Proposer supports the conclusions of the SBH 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; 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)).

## 1.3 Proposed Modification

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>7</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. 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 to 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 liabilities incurred in execution of role as a BSCCo Director	Consistent with existing provisions in Code and BSCCo Articles of Association (AA) for	Existing Code (C4.5.1) and AA provisions

<sup>7</sup> The rights of Industry Directors and Other Directors are not identical (e.g. remuneration).

		existing Directors	would apply
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## 1.4 Issues raised by the Proposed Modification

During the course of the Assessment Procedure, the GSMG considered the following issues:

- Rationale for existing non-executive Board
- Potential advantages of Executive Directors;
- Attendees versus Directors;
- Case for Proposed Executive Directors;
- Potential Conflict of Roles for Executive Directors;
- Balance of proposed Board structure;
- Appropriateness of proposed Board structure for a non-profit organisation; and
- Potential Alternative Modifications.

The following subsections document the discussions and conclusions of the GSMG in relation to each of the above issues.

### 1.4.1 Rationale for Existing non-Executive Board

The GSMG recognised that whilst industry members had various personal memories of the rationale for the current Board structure, the only formal documentation which had been found was that quoted in Para 1.2.1.2 above. This did allude to the non-executive nature of the Board.

The GSMG noted the presumed rationale for an entirely non-executive Board membership reported in the SBH report (see Annex 6). First, to ensure BSCCo operates as a responsive and essentially administrative organisation, rather one pursuing its own agenda. Second, to ensure BSCCo remains 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 executives.

### 1.4.2 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 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<sup>8</sup> view that adding executives to the Board would facilitate more efficient communication between those responsible for implementing company policy (i.e. the BSCCo executive) 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 6). 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 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.

### **1.4.3 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

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<sup>8</sup> Please note that there was a clear distinction in the role of the ELEXON GSMG members and the ELEXON attendees:

- David Warner and Roger Salomone were GSMG members, acting 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 the Board and its Directors. Gareth Forrester, manager of ELEXON's Governance and Regulatory Affairs team, was present to present and explain the SBH report's recommendations.

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.

a company and for breach of statutory duty<sup>9</sup>. The GSMG noted the ELEXON view that Executive Directors might be best placed to bring operational issues to the attention of the Board and challenge policy which they believe could adversely affect the interests of the company. Executives attending Board meetings may, and probably do, endeavour to act in such a manner. However, a statutory and common law obligation 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. Attendees at the Board would, in the end, be providers of information to the decision making process, whilst Executive Directors would be a full part of that process right up to and including voting.

However, the GSMG considered 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.

For example, the GSMG noted that the Board has passed a resolution requiring BSCCo's Chief Executive and "Chief Financial Officer" to attend Board meetings, and allowing them to participate fully (short of voting). It was further noted that other members of the ELEXON executive now had a 'standing invitation' to attend Board meetings.

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 legal duties (and potential consequences) of directorship on BSCCo executives could 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, it was considered 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.

The GSMG noted ELEXON's concern that attendance might not deliver the full benefits that directorship would. However, the majority of the GSMG concluded that attendance at Board meetings by executives should facilitate communication between the Board and the Executive and enhance the scrutiny of BSCCo by the Board. Moreover, one member of the GSMG noted that the Board had only recently passed the resolution requiring BSCCo's Chief Executive and "Chief Financial Officer" to attend Board meetings. Therefore, it would be best to wait and see if attendance delivers the improvements sought by P161 before making potentially unnecessary changes.

One member of the GSMG, the Proposer, concluded that, to realise the improvements sought by P161, adding Executive Directors to the Board was essential. Executive attendees would be inclined to provide parochial views (based on the perspectives of the departments for which they are responsible) whilst Executive Directors would have a legal duty to take a company-wide perspective, a legal duty which would provide an incentive for those executives to take a more critical view of proposed policy. In addition, by virtue of being entitled to participate fully in all Board discussions, Executive Directors would be better able to communicate Board decisions to the rest of the executive and BSCCo, than if they were only entitled to attend Board meetings.

One member of the GSMG commented that, whilst this may be the case with departmental heads, the Chief Executive, when attending the Board, ought not to be constrained by a 'parochial' or departmental perspective.

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<sup>9</sup> Note that there is no legal distinction between 'executive' and 'non-executive' directors.

#### 1.4.4 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 unanimously concluded that, given the nature of the improvements sought by P161, 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 a greater emphasis on and effectiveness in Board scrutiny of operations, budgets and costs.

In addition, 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*.

#### 1.4.5 Potential Conflict of Roles for Executive Directors

Several members of the GSMG expressed a concern that a “conflict of role” may exist for Executive Directors who would be charged with both presenting the case for a policy or plan (e.g. a budget) and challenging and scrutinising it. This potential conflict of role could undermine the scrutiny of BSCCo by the Board. One GSMG member, in support of this concern, quoted from the Higgs Report on non-executive directors (Reference 7):

*“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 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>10</sup>*

Those GSMG members concerned by this potential conflict of interests noted that independent scrutiny by a non-executive Board appeared to have been a key consideration when the current Board structure was devised.

One member of the GSMG, the Proposer, expressed a counter-argument to this concern – unlike executive attendees, Executive Directors would 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). Therefore, the accountability of BSCCo to the Board and scrutiny of BSCCo by the Board would be enhanced by making BSCCo executives Directors. Placing the legal duties of directorship on the potentially most influential BSCCO executive roles – those of Chief Executive and ‘Chief Financial Officer’<sup>11</sup> – would reduce the risk of a conflict of interest emerging in the management of BSCCo. Moreover, this member of the GSMG noted that, under P161, there would still be a non-executive majority on the Board whose role it would be to prevent executive ‘capture’ of the Board.

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 to shareholders than exists for BSCCo.

<sup>10</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).

<sup>11</sup> The term ‘Chief Financial Officer’ was used interchangeably with, and as short-hand for, a senior BSCCo executive holding a commercially and financially orientated position.

The majority of the GSMG concluded that, however unlikely, P161 could only increase the risk that a conflict of interest would be introduced into Board deliberations – because at present there were no BSCCo executives on the Board. Furthermore, introducing this risk and reducing the accountability of BSCCo was unnecessary given that it appeared that the objectives of P161 should be realisable within the current Board structure (i.e. through attendance of Board meetings by BSCCo executives).

#### **1.4.6 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 the balance between Industry Directors, representative of those who fund BSCCo, and the other categories of Directors was 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, set of experiences and areas of 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 considered 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 legal duties of directorship, might broaden the perspective of the Board and deepen scrutiny of the company. However, the majority of GSMG members considered that ensuring that an operational perspective was included in Board discussions could equally be achieved by requiring 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 2 out of 5 as at present. However, as a counter-argument, it was noted that all Directors have a legal 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.

The majority of the GSMG concluded that the influence of the industry perspective on Board business would be diluted – by virtue of moving from an entirely non-executive Board, to one including BSCCo executives.

One member of the GSMG, the Proposer, was of the opinion that P161 would not dilute the influence of the industry perspective on Board business – the existing Industry Directors would still be present and able to fully participate in deliberations. In any case, this 'dilution', ultimately, should only be a concern if one believes that both Industry Directors consistently vote the same way and in a different way from the other Directors. Moreover, the existing arrangements, under which the Chairman of the Board has discretion over the appointment of the two "Other Directors", provides a mechanism through which views and expertise which are not considered adequately represented may be brought onto the Board.

#### **1.4.7 Appropriateness of Proposed Board Structure for a non-Profit Organisation**

The GSMG considered whether or not the proposed Board structure (i.e. a mixed executive/non-executive Board) would be appropriate for a non-profit organisation such as BSCCo.

The GSMG noted that SBH reported that many non-profit organisations are now moving away from wholly non-executive boards, quoting Ofgem, the Financial Services Authority, the Office for Fair Trading and the Department for Trade and Industry as examples (see Annex 6). 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>12</sup>*

The GSMG considered that what was most relevant was not so much 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 market operators funded by industry) with such governance. However, the GSMG recognised that the boards of such companies would reflect the specific 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>13</sup> and 'system operator'<sup>14</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.

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.

Whilst considering the particular case of BSCCo, the GSMG noted that a strong executive presence on a board is often seen as good practice (e.g. in the Combined Code on Corporate Governance<sup>15</sup>, Reference 8). 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".

The GSMG concluded that the more important consideration in the governance of BSCCo was not the company's not-for-profit status, but its funding arrangements. BSCCo receives guaranteed funding from the industry to cover its expenditure. This differs from non-profit organisations like charities, many of which face significant competition (from other charitable organisations) for contributions. Therefore, independent scrutiny is an essential element in the regulation of BSCCo expenditure.

The majority of the GSMG noted that separation of the Board and the BSCCo management, through an entirely non-executive Board, appeared to have been considered an important element in facilitating

<sup>12</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)

<sup>13</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>14</sup> The 'system operator' role comprises responsibility for the management and maintenance of the technical operating standards of the power system.

<sup>15</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).

independent scrutiny by Ofgem/DTI whilst devising the current Board structure. However, one member of the GSMG, the Proposer, indicated that this 'separation' was a false dichotomy – the Board and BSCCo both shared the same fundamental objective of delivering efficient Balancing and Settlement arrangements.

#### **1.4.8 Potential Alternative Modifications**

The GSMG identified and considered four potential Alternative Modifications, each of which, to varying degrees, it considered might go some way to addressing two of the GSMG's principal concerns:

1. potential conflict of roles for Executive Directors; and
2. potential dilution of the industry perspective.

Note that each of the four potential Alternative Modifications would be an extension to the Proposed Modification – i.e. Proposed Modification as submitted (add two Executive Directors to the Board) plus additional provisions.

The subsections provide a description of each potential Alternative Modification identified and summarise the GSMG's discussions and conclusions on each.

##### ***1.4.8.1 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 initially believed 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.

However, upon further consideration, the GSMG concluded that the benefits of this potential Alternative Modification, as compared to the Proposed Modification, would be outweighed by the anomalous situation in which it would place Executive Directors – i.e. full legal duties of directorship without being able to vote on the most significant single element of Board business, the Annual Budget. As a consequence, this option raised the practical question as to whether or not, in such circumstances, suitably qualified and willing candidates could be found for the Executive Director positions. The GSMG noted that were willing candidates found, and were they able to secure legal protection from potential liabilities arising from Board decisions on the Annual Budget, the accountability of the Executive Directors would become questionable. Executive Directors would be able to participate fully in Board deliberations over the Budget, potentially significantly influencing those decisions, without being potentially liable for any decisions made.

The GSMG also noted that the Annual Budget was widely communicated, and that any adverse comments from Parties would come to the attention of Independent Board Members. This transparency was in itself a safeguard. On the other hand, the Board's more routine consideration of financial matters throughout the year was not so transparent, but, the GSMG considered, it would be unfeasibly complex to restrict voting rights of Executive Directors in regard of all such financial Board business.

The GSMG considered that the disadvantages of this option outweighed the advantages and thus decided not to develop this option into an Alternative Modification.

### **1.4.8.2 Option 2: Weighted Voting Rights for Executive 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 initially believed 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, there appeared to be no satisfactory justification for weighting the 'industry perspective' and the perspectives of the individual Industry Directors. Second, the perspective of other non-executive Directors might be diluted.

Upon further consideration, the GSMG concluded that the benefits of this potential Alternative Modification, as compared to the Proposed Modification, would be outweighed by disadvantages – the views of individual Industry Directors and Industry Directors as a group, when it came to a vote, would be privileged and given a greater influence over Board decisions despite all Directors having the legal duty to act in the company's best interests. Moreover, under this option the potential for a conflict of role for Executive Directors would remain and the perspective of other non-executive Directors might be diminished as compared that of Industry Directors.

The GSMG considered that the disadvantages of this option outweighed the advantages and thus decided not to develop this option into an Alternative Modification.

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

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

The GSMG believed 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 categories of Directors and the individuals within those categories.

However, the GSMG identified several practical concerns with this option. First, the cost of the Board could increase as a result of additional expenses being incurred and claimed (although this was not considered to be 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 Code were this option developed further.

In addition, as with option 2, option 3 would vest greater influence in a particular category of Directors (i.e. Industry Directors) and potentially dilute the perspective of the other non-executive Directors (i.e. those Directors appointed by the Chairman of the Board).

The GSMG considered that the disadvantages of this option outweighed the advantages and thus decided not to develop this option into an Alternative Modification.

#### **1.4.8.4 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 believed 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.

As with option 1, the asymmetry between the rights and duties of Executive Directors under this option (i.e. full legal duties of directorship without being able to vote on Board decisions) raised the practical consideration that it might be difficult to find candidates to fill these roles. In addition, it was unclear whether or not Executive Directors would be able to be held accountable for Board decisions under this option and, as consequence whether or not the additional incentive to act in the company's best interest would exist.

ELEXON indicated that, whilst no legal restrictions on prohibiting the Executive Directors from voting had yet been found, were this option to be progressed further legal advice 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. As a consequence, this option was not consulted on and the GSMG decided not to develop it into an Alternative Modification.

### **1.5 Assessment of whether the Proposed Modification would better facilitate the Applicable BSC Objectives**

The GSMG agreed that the relevant Applicable BSC Objective for the assessment of P161 was (d) - *the promotion of efficiency in the implementation and administration of the balancing and settlement arrangements*. The GSMG noted that Applicable BSC Objective (c) - *the promotion of effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity* – had also been cited by the Proposer as being better facilitated through implementation of P161. The GSMG considered that impact on Applicable BSC Objective (c) (e.g. a more effective Board, by applying more effective cost control, might reduce the financial barriers to entry) would be very much a second order effect.

The majority of the GSMG concluded that, on balance, P161 would not better facilitate achievement of Applicable BSC Objective (d). The case for change had not been proven, in particular there appeared to be no additional, quantifiable, benefit that would be realised by making executives Directors rather than requiring them to attend Board meetings and participate in discussions where necessary. Moreover, P161 would introduce the risk of a conflict of roles for the Executive Directors (i.e. between their positions as managers and Directors) which could undermine the effective scrutiny and thus accountability of BSCCo. One of those GSMG members unconvinced that the change proposed by P161 was necessary noted that the latest Business Strategy and Annual Budget forecast decreasing BSCCo costs over the next three years.

One GSMG member believed that P161 would actually detract from achievement of Applicable BSC Objective (d) by reducing the accountability of BSCCo. Accountability is an incentive for efficiency, and the perception that BSCCo is accountable is essential for market participants' confidence in the trading

arrangements. Removing the clear distinction between the Board and the BSCCo management that currently exists would undermine the ability of the Board to exercise effective control over BSCCo costs.

However, one GSMG member, the Proposer, believed that P161 would better facilitate achievement of Applicable BSC Objective (d). P161 would enhance communication between Board and management by full involvement of BSCCo executives in Board decision-making and providing the Board with a greater insight into how BSCCo is managed on a day-to-day basis. Furthermore, P161 would enhance the accountability of the most senior, and potentially most influential, BSCCo executives to stakeholders. As Directors, these executives would assume a legal responsibility to act in the best interests of the company, whose objective is the delivery of efficient balancing and settlement arrangements, and be liable for failing to discharge that responsibility. This GSMG member acknowledged improvements to working practices could deliver some of the benefits sought by P161, but noted that structural reform was the best way to ensure these benefits are realised and persist. Working practices and incumbents on the Board change over time, whereas the legal duties of directorship do not.

## 1.6 Alternative Modification

The GSMG, whilst having considered a number of alternative solutions, concluded that there was no Alternative Modification which would better facilitate the Applicable BSC Objectives as compared to the Proposed Modification.

## 1.7 Governance and regulatory framework assessment

No impact on the statutory, regulatory and contractual framework within which the Code sits was identified.

## 2 COSTS<sup>16</sup>

### PROGRESSING MODIFICATION PROPOSAL

<b>Demand Led Cost</b>	0
<b>ELEXON Resource</b>	43 Man days £ 15,920

### IMPLEMENTATION COSTS

		Stand Alone Cost	P161 Incremental Cost	Tolerance
<b>Service Provider<sup>17</sup> Cost</b>				
	Change Specific Cost	0	0	N/a

<sup>16</sup> Clarification of the meanings of the cost terms in this section can be found in annex 7 of this report

<sup>17</sup> BSC Agent and non-BSC Agent Service Provider and software Costs

	Release Cost	0	0	N/a
	Incremental Release Cost	0	0	N/a
	Total Service Provider Cost	0	0	N/a
<b>Implementation Cost</b>				
	External Audit	£	£	N/a
	Design Clarifications	£	£	N/a
	Additional Resource Costs	0	0	N/a
	Additional Testing and Audit Support Costs	0		N/a
<b>Total Demand Led Implementation Cost</b>		0	0	N/a

<b>ELEXON Implementation Resource Cost</b>		10 Man days £4,000	10 Man days £4,000	N/a
<b>Total Implementation Cost</b>		£	£	N/a

### ONGOING SUPPORT AND MAINTENANCE COSTS

	Stand Alone Cost	P161 Incremental Cost	Tolerance
Service Provider Operation Cost	0	0	N/a
Service Provider Maintenance Cost	0	0	N/a
ELEXON Operational Cost	negligible (i.e. expenses )	negligible (i.e. expenses )	N/a

### 3 RATIONALE FOR MODIFICATION GROUP'S RECOMMENDATIONS TO THE PANEL

The majority of the GSMG believes that P161 would not better facilitate the Applicable BSC Objectives. Therefore, by a majority, the GSMG recommends that the Panel:

- AGREE that the Proposed Modification P161 should not be made;
- AGREE a provisional Implementation Date for Proposed Modification P161 of 30 Working Days after an Authority decision;

- AGREE that Modification Proposal P161 be submitted to the Report Phase; and
- AGREE that the draft Modification Report be issued for consultation and submitted to the Panel Meeting of 13 May 2004.

The GSMG's assessment of P161 in terms of the Applicable BSC Objectives is contained in Section 1.5 (above) and the rationale for the proposed Implementation Date is contained in Section 9 (below).

## 4 IMPACT ON BSC SYSTEMS AND PARTIES

An assessment has been undertaken in respect of BSC Systems, BSCCo and Parties. No material impacts have been identified.

The GSMG acknowledges that the two Executive Directors would be entitled, under Section C of the Code, to re-imburement by BSCCo for "reasonable" costs and expenses incurred as a consequence of Board business. However, the GSMG does not consider that this would represent a material impact, especially given that the Executive Directors would be BSCCo employees and that Board meetings are held at BSCCo's offices.

## 5 IMPACT ON CODE AND DOCUMENTATION

### 5.1 Balancing and Settlement Code

Implementation of P161 would require changes to Section C "BSCCo and its Subsidiaries" and Annex X-1 "General Glossary" of the Code. The changes that would be required are summarised in the table below:

Code Section	Change(s) Required
Section C "BSCCo and its Subsidiaries"	<ul style="list-style-type: none"> <li>▪ Expand Board to include BSCCo "Chief Executive" and "Chief Financial Officer"</li> <li>▪ Provide BSCCo "Chief Executive" and "Chief Financial Officer" with same provisions regarding remuneration as "Industry Directors"</li> <li>▪ Remove restriction on BSCCo Chief Executive being a Director of the Board</li> <li>▪ Add provision that BSCCo Chief Executive and Chief Financial Officer may not be the same person</li> <li>▪ Specify that the directorships of the BSCCo "Chief Executive" and "Chief Financial Officer" end when the incumbents cease to hold those offices</li> </ul>
Annex X-1 "General Glossary"	Add entry for "Chief Financial Officer"

Draft legal text is attached as Annex 1 of this report.

### 5.2 Code Subsidiary Documents

Implementation of P161 would have no impact on any of the Code Subsidiary Documents.

### 5.3 BSCCo Memorandum and Articles of Association

Implementation of P161 would require changes to BSCCo's Articles of Association. The maximum permissible number of Directors would need to be raised from five to seven. The changes that would be required are attached as Annex 5 of this report.

### 5.4 Impact on Core Industry Documents and supporting arrangements

Implementation of P161 would not impact any of the Core Industry Documents, or the supporting arrangements.

## 6 SUMMARY OF CONSULTATIONS

A consultation document was issued on 10 March 2004, with a deadline for responses of 19 March 2004. Eleven responses (52 Parties) were received<sup>18</sup>. The responses are attached as Annex 3 of this report.

A majority of the GSMG believed that, given that Board deliberations are confidential and not directly visible to the GSMG or the wider industry, a Board perspective on the areas for improvement and the solution suggested in P161 might be helpful. Therefore, the consultation document was also issued to the Board, in addition to the usual recipients, in order to provide it with the opportunity to input into the P161 Assessment Procedure should it consider it appropriate. No formal response to the consultation document was received from the Board. The GSMG Chairman was, however, informed by BSCCo's Company Secretary, that while the Board did not want to seem unhelpful, it did not consider it appropriate to formally comment on any Proposed Modification as the question of a Code change was a matter for the Modification Procedure set out in Section F of the Code. The Board did not wish to appear to be influencing the consideration of the Modification Proposal and was of the view that all the relevant issues had been brought forward.

Consultation question	Agree	Disagree	Undecided / No Comment
Do you believe Proposed Modification P161 would better facilitate achievement of the Applicable BSC Objectives?	1	9	1
Do you believe that any of the potential Alternative Modifications identified by the GSMG would better facilitate achievement of the Applicable BSC Objectives as compared to the <b>Proposed Modification</b> :	A – 4	A – 6	A – 1
B – 3	B – 7	B – 1	
a. Restricted Voting Rights for Executive Directors (i.e. Option 1)?	C – 5	C – 5	C – 1
b. Weighted Voting Rights for Industry Directors (i.e. Option 2)?			
c. Additional Industry Directors (i.e. Option 3)?			
Do you believe that the potential Alternative Modifications identified by the GSMG would better facilitate achievement of the Applicable BSC Objectives as compared to the <b>current Code baseline</b> :	A – 1	A – 9	A – 1
B – 1	B – 9	B – 1	
a. Restricted Voting Rights for Executive Directors (i.e. Option 1)?	C – 1	C – 9	C – 1
b. Weighted Voting Rights for Industry Directors (i.e. Option 2)?			
c. Additional Industry Directors (i.e. Option 3)?			
Do you believe that there are any alternative solutions that the GSMG has not identified and that should be considered?	1	9	1

<sup>18</sup> Please note that the answers received from British Energy were clarified and revised after receipt. When writing their response, British Energy had been under the misapprehension that Option 3 constituted adding two additional Industry Directors to the Board without adding two executive directors. The summary contained in this section reflects their revised opinions based on the understanding that option 3 would involve adding two Industry Directors and two executive directors to the Board.

Consultation question	Agree	Disagree	Undecided / No Comment
It has been suggested that executive input into Board business and an executive presence at Board meetings would provide benefits in terms of communication (between BSCCo Executive and the Board) and scrutiny (of BSCCo by non-executive Directors). In your opinion: a. To what extent would these benefits be delivered by requiring the relevant BSCCo executives to attend all Board meetings? b. To what extent would these benefits be delivered by making the relevant BSCCo executives Directors of the Board?	A – Fully 8 Partially 1 B – Fully 3 Partially 3	A – 0 B – 3	A – 2 B – 2
Do you agree with the GSMG that the most appropriate second BSCCo executive to add to the Board (i.e. in addition to the Chief Executive) would be one holding a commercially and financially orientated role?	6	3	2
Do you believe that an appropriate balance between executive and non-executive views would be achieved under: a. The Proposed Modification? b. Restricted Voting Rights for Executive Directors (i.e. Option 1)? c. Weighted Voting Rights for Industry Directors (i.e. Option 2)? d. Additional Industry Directors (i.e. Option 3)?	A – 2 B – 4 C – 4 D – 7	A – 8 B – 6 C – 6 D – 3	A – 1 B – 1 C – 1 D – 1
Do you believe that an appropriate balance between industry and non-industry views would be achieved under: a. The Proposed Modification? b. Restricted Voting Rights for Executive Directors (i.e. Option 1)? c. Weighted Voting Rights for Industry Directors (i.e. Option 2)? d. Additional Industry Directors (i.e. Option 3)?	A – 1 B – 3 C – 3 D – 7	A – 9 B – 6 C – 7 D – 3	A – 1 B – 2 C – 1 D – 1
Do you believe that the Proposed Modification would introduce a potential conflict of roles for Executive Directors (i.e. between their role as managers and their role as Directors)?	8	1	2
If you believe that the Proposed Modification would introduce a conflict of roles for Executive Directors (i.e. between their role as managers and their role as Directors), do you believe that under the potential Alternative Modifications identified by the GSMG that conflict would be avoided: a. Restricted Voting Rights for Executive Directors (i.e. Option 1)? b. Weighted Voting Rights for Industry Directors (i.e. Option 2)? c. Additional Industry Directors (i.e. Option 3)?	A – 2 B – 0 C – 0	A – 6 B – 8 C – 8	A – 3 B – 3 C – 3
Do you believe that the Board structure proposed under P161 would be appropriate for a non-profit company such as BSCCo?	1	8	2
Do you believe that the Board structures of any of the potential Alternative Modifications identified by the GSMG would be appropriate for a Non-Profit company such as BSCCo? a. Restricted Voting Rights for Executive Directors (i.e. Option 1)? b. Weighted Voting Rights for Industry Directors (i.e. Option 2)? c. Additional Industry Directors (i.e. Option 3)?	A – 2 B – 1 C – 2	A – 5 B – 7 C – 6	A – 4 B – 3 C – 3
Do you agree with the Code rights and obligations of the proposed Executive Directors as established by the GSMG?	6	4	1
Are there any further comments on P161 that you wish to make?	4	6	1

The following subsections summarise the responses received to each of the questions posed.

## **6.1 Proposed Modification, potential Alternative Modifications and Applicable BSC Objectives**

### **6.1.1 Proposed Modification and Applicable BSC Objectives**

The majority of respondents believed that P161 would not better facilitate the Applicable BSC Objectives. The main rationale provided for this position was that the case for change had not been proven, in particular that directorship would deliver additional benefits as compared to attendance, and that the existing arrangements were satisfactory. One respondent developed this argument further, commenting that both the original rationale for the current Board structure and the shortcomings identified in it by P161 were not clear. Several respondents, some of whom quoted the rationale for the current Board structure provided in the DTI/Ofgem Conclusions Document (see Section 1.2.1.2), indicated that a mixed Board might reduce effective scrutiny of BSCCo and control of its costs owing to the potential conflict of interests that it would introduce.

One respondent believed that P161 would better facilitate Applicable BSC Objective (c), primarily, and Applicable BSC Objective (d) to a lesser extent. The addition of Executive Directors to the Board would enhance the financial scrutiny of BSCCo and control of its costs. As a consequence, BSCCo expenditure and industry costs would probably be reduced, thus reducing financial barriers to entry into the market. This respondent also commented that P161 would retain a majority of non-executive Directors on the Board, which would act as a check on any executive ambition.

One respondent made no comment.

### **6.1.2 Potential Alternatives and Proposed Modification**

The majority of respondents believed that options 1 and 2 would not better facilitate the Applicable BSC Objectives as compared to the Proposed Modification. In respect of option 1, these respondents noted that all Directors should have equal status and be fully accountable for the financial governance of BSCCo, and, in respect of option 2, they noted that it would not be appropriate to vest a greater level of influence in both individual Directors and a specific group of Directors. The minority of respondents who believed that options 1 and 2 would better facilitate the Applicable BSC Objectives as compared to the Proposed Modification, did so on the basis that option 1 would militate against the risk of a conflict of roles and option 2 would better maintain the balance of views on the Board.

Respondents were evenly split on option 3. Those believing it to be superior to the Proposed Modification indicated that it would maintain a more appropriate balance of views, limit the impact of the potential conflict of roles and bring additional expertise onto the Board. Those against it indicated that it risked reducing the efficiency of the Board and acknowledged that there might be practical difficulties recruiting additional Panel members as Industry Directors, given that a limited pool of personnel existed.

One respondent believed that option 4 would be superior to the Proposed Modification, in that it would go the furthest in reducing the potential for a conflict of roles for Executive Directors

One respondent made no comment.

### **6.1.3 Potential Alternatives and Current Baseline**

The majority of respondents believed that none of the potential Alternative Modifications would be superior to the current arrangements. Whilst, to varying degrees, each might go some way to militating against the potential for a conflict of roles and addressing the concern that the industry perspective would be diluted, these concerns would remain were executives added to the Board.

One respondent believed that options 1, 2 and 3 would all better achieve the Applicable BSC Objectives as compared to the current arrangements by virtue of bringing Executive Directors, and the associated benefits, onto the Board. However, this respondent noted that option 1 would not deliver the full benefits of the Proposed Modification, by restricting the role of Executive Directors, option 2 was not consistent with 'best practice' and that option 3 risked reducing the efficiency of the Board.

One respondent made no comment.

## **6.2 Other Solutions**

One respondent noted that further potential Alternative Modification would be to add the two proposed Executive Directors, an additional Industry Director and an additional Director selected by the Chairman. This respondent commented that this would better maintain the current balance as compared to option 3.

The GSMG was of the opinion that this potential Alternative Modification would have all the drawbacks of option 3. Therefore, as with option 3, the GSMG decided not to develop this proposition into an Alternative Modification.

## **6.3 Attendance versus Directorship**

The majority of respondents believed that attendance of Board meetings by BSCCo executives should address the issues identified in the Proposed Modification, and questioned what additional benefits adding BSCCo executives to the Board would yield. One respondent added that Executive Directors would confuse communication lines and be under conflicting objectives.

One respondent indicated that whilst attendance would deliver some of the benefits sought by the Proposed Modification, only attendance would deliver the full benefits. This respondent expressed a concern that executive attendees, who would not be under the legal obligations of directorship, would be inclined to take parochial views based on their managerial responsibilities rather than a company-wide perspective. Furthermore, Executive Directors, having been fully involved in Board decisions and discussions, would be better able to communicate those decisions within BSCCo.

One respondent made no comment.

## **6.4 CFO Most Appropriate Second Executive to Add?**

The majority of respondents agreed that, were BSCCo executives to be added to the Board, it would be most appropriate to add the 'Chief Financial Officer' (i.e. a senior executive with a commercially or financially orientated role). These respondents considered that this would be in line with current 'best practice' and best meet the main objective of the Proposed Modification – enhanced financial scrutiny and cost control.

A minority of respondents indicated that they did not support adding the Chief Financial Officer to the Board, because they were opposed to adding any BSCCo executives to the Board.

Two respondents made no comment.

## **6.5 Balance of Board**

### **6.5.1 Executive/non-Executive Balance**

The majority of respondents believed that the Proposed Modification would not result in an appropriate balance between executive and non-executive views. The main rationale for this position was that the balance would inevitably be weakened by virtue of adding executives to the Board and the associated risk of a conflict of interests being introduced to Board business.

A minority of respondents believed that, under the Proposed Modification, an appropriate balance would be retained because the majority of Board members would still be non-executive.

One respondent made no comment.

The majority of respondents were of the opinion, that under option 1, an appropriate balance would not be achieved because on the majority of Board business Executive Directors would be able to vote and a potential conflict of interests introduced. One respondent believed that the balance would not be appropriate because the accountability of the Board would be undermined by a category of Director that would not be fully involved in the key area of the Budget.

A minority of respondents believed that option 1 would result in an appropriate balance, by militating against the risk of Budget decisions being undermined by a conflict of interest.

One respondent made no comment.

The majority of respondents believed that option 2 would not result in an appropriate balance, because the fundamental concern of a potential conflict of interest would not be addressed and an inappropriate level of power would be vested in a specific type of Director.

A minority of respondents were of the opinion, that under option 2, a clear non-executive majority would be retained.

One respondent made no comment.

The majority of respondents believed that option 3 would result in an appropriate balance of views on the Board, by ensuring that the Industry perspective was not diminished. However, several of these respondents noted that this may come at the expense of reduced efficiency and that there was a limited pool of Industry Panel members from which to draw additional Industry Directors.

A minority believed that the current structure achieved an appropriate balance and that this should not be altered through the addition of Executive Directors – regardless of whether or not additional Industry Directors are added as a counter-balance.

One respondent made no comment.

### **6.5.2 Industry/non-Industry Balance**

The majority of respondents believed that the Proposed Modification would not result in an appropriate balance between industry and non-industry views. The main rationale for this position was that the existing balance would inevitably be weakened by virtue of adding executives to the Board.

One respondent believed that, under the Proposed Modification, an appropriate balance of views would be retained because the majority of Board members would still be non-executive and the Industry view would still be represented.

One respondent made no comment.

The majority of respondents were of the opinion that, whilst delivering a better Board structure than the Proposed Modification, option 1 would distort the existing balance on the majority of Board business. One respondent believed that the balance would not be appropriate because the accountability of the Board would be undermined by a category of Director that would not be fully involved in the key area of the Budget.

A minority of respondents believed that option 1 would deliver an appropriate balance between industry and non-industry views, because it would militate against the risk of a conflict of interest being introduced by executives into the key area of decision-making – the Budget.

One respondent made no comment and one respondent remained undecided, noting that option 1 needed to be developed further before an opinion could be provided.

The majority of respondents believed that option 2 would not result in an appropriate balance, because the fundamental concern of a potential conflict of interest would not be addressed and an inappropriate level of power would be vested in a specific type of Director. One respondent commented that a further disadvantage to this option was unnecessary complexity.

A minority of respondents were of the opinion that option 2 would deliver an appropriate balance of views by addressing the concern that the influence of the industry perspective would be diluted. However, one of these respondents noted that this option was not in accordance with what is commonly understood to be 'best practice' in corporate governance.

One respondent made no comment.

The majority of respondents believed that option 3 would result in an appropriate balance of views on the Board, by ensuring that the Industry perspective was not diminished. However, several of these respondents noted that this may come at the expense of reduced efficiency and that there was a limited pool of Industry Panel members from which to draw additional Industry Directors.

A minority believed that the current structure achieved an appropriate balance and that this should not be altered through the addition of Executive Directors – regardless of whether or not additional Industry Directors are added as a counter-balance.

One respondent made no comment.

## **6.6 Potential Conflict of Roles**

### **6.6.1 Proposed Modification**

The majority of respondents believed that the Proposed Modification would introduce a potential conflict of roles for Executive Directors (i.e. between their role as managers and their role as Directors). Several respondents expressed particular concern that a conflict might emerge in the area of expenditure – i.e. where executives would be responsible for identifying, scrutinising and approving budgetary requirements.

One respondent indicated that whilst a conflict of roles might not be introduced, this may have been the concern that resulted in the current wholly non-executive Board.

One respondent did not believe that a conflict of roles would be introduced, noting that all Directors are under the same legal obligation to act in the best interests of the company. Furthermore, the Proposed Modification would retain a majority of non-executives, whose responsibility it would be to check any executive ambition.

One respondent did not comment.

### **6.6.2 Potential Alternative Modifications**

The majority of respondents believed that option 1 would not avoid the potential for a conflict of roles that the Proposed Modification would introduce. Whilst some respondents acknowledged that option 1 would militate against this risk, the potential for the conflict would still be present.

Two respondents believed that, by excluding Executive Directors from voting on the Budget, the risk of a conflict of roles would be avoided in the key area of Board decision-making.

One respondent indicated that the question was not applicable from their perspective, because they were of the opinion that the Proposed Modification would not introduce the potential for a conflict of roles.

Two respondents made no comments.

The majority of respondents believed that neither option 2 nor option 3 would avoid the potential inherent in the Proposed Modification for a conflict of roles. Some respondents acknowledged that both options would go some way to addressing the issue, additional Industry Directors or weighted votes for Industry Directors would minimise the effect of the conflict of interest should it manifest itself.

One respondent indicated that the question was not applicable from their perspective, because they were of the opinion that the Proposed Modification would not introduce the potential for a conflict of roles.

Two respondents made no comments.

One respondent noted that option 4 (which was not consulted on, but noted in the consultation document as having been discussed and rejected), whereby Executive Directors would be excluded from all Board votes, would militate against the risk of a conflict of roles.

## **6.7 Proposed Board Structure & Non-Profit Organisations**

The majority of respondents believed that Board structure which would result from the Proposed Modification would not be appropriate for a non-profit organisation such as BSCCo. One of these respondents indicated that, given BSCCo's funding arrangements, independent budgetary control was a central issue. Two respondents indicated that the clear separation of management and board was essential in a company such as BSCCo; one of these respondents added that separation was essential to avoid conflicting objectives.

One respondent believed that the Board structure under the Proposed Modification would be appropriate for BSCCo. This respondent noted that the SBH report provided several examples of non-profit organisations with mixed boards.

One respondent indicated that the "appropriateness" of the Board structure was not the relevant test, which was the Applicable BSC Objectives.

One respondent did not comment.

The majority of respondents indicated that none of the three potential Alternative Modifications would deliver a Board structure appropriate for a company such as BSCCo.

A minority of respondents believed that some of the options would result in more appropriate Board structures than the Proposed Modification; one noted that option 1 may be appropriate, depending on the scope of the restriction of the voting rights of Executive Directors. However, none of those respondents indicated that the resulting structures would be better than the existing arrangements.

One respondent indicated that all three options would be appropriate for BSCCo, but not more so than the Proposed Modification.

One respondent indicated that the "appropriateness" of the Board structure was not the relevant test, which was the Applicable BSC Objectives.

One respondent indicated that option 4 would be appropriate.

One respondent did not comment.

## **6.8 Code Rights & Obligations**

The majority of respondents indicated that, were Executive Directors added to the Board, the Code rights and obligations proposed by the GSMG were consistent with those of "Other Directors" and with "best practice".

A minority of respondents did not agree with the Code rights and obligations proposed by the GSMG, because they did not support the addition of Executive Directors to the Board.

One respondent did not comment.

## **6.9 Further Comments**

Four respondents provided further comments.

One emphasised that, given the cost-recovery structure of the current funding arrangements, they did not believe that the "devolution of greater financial control to BSCCo employees would serve the best interests of the Code".

One commented that they saw no benefit to the Industry from the proposed changes and that "one member (NGC) should not be bringing forward proposals to make changes which just serve to increase the role of Elexon executive directors." Another respondent made a similar point, that they considered it "inappropriate for NGC to bring forward changes that impact on BSC governance".

Finally, one respondent commented that, given the potentially fundamental impact that it would have on the development of BSCCo, P161 may have benefited from a longer Assessment Procedure. At the final meeting of the Assessment Procedure, having considered the consultation responses, the GSMG unanimously agreed that all the necessary work had been undertaken and that there would be no benefit to extending the Assessment Procedure further.

## **6.10 Comments and views of the Modification Group**

The GSMG took into account the consultation responses during its assessment.

The GSMG noted that majority of respondents did not believe that P161 would better facilitate achievement of the Applicable BSC Objectives and that this was primarily because the case for change had not been proven. In addition, the GSMG noted that a key concern appeared to be that BSCCo's funding arrangements made a fully independent Board crucial for the purpose of cost control.

## **7 SUMMARY OF TRANSMISSION COMPANY ANALYSIS**

The Transmission Company reported that implementation of P161 would have no impact on it.

## **8 SUMMARY OF EXTERNAL ADVICE**

No external advice was sought by the GSMG.

## **9 IMPLEMENTATION APPROACH**

The GSMG recommends an Implementation Date of 30 Working Days after an Authority decision. This would provide sufficient time to make the required changes to the Articles of Association and appoint two Executive Directors.

It is estimated that making the necessary changes to the Code and Articles of Association would require 10 Man Days of ELEXON effort.

## 10 DOCUMENT CONTROL

### 10.1 Authorities

Version	Date	Author	Reviewer	Change Reference
0.1	30.03.04	Change Delivery	GSMG	Initial Draft
0.1	30.03.04	Change Delivery	Change Delivery	Initial Draft
0.2	01.04.04	Change Delivery	GSMG	Revised Draft
0.3	01.04.04	Change Delivery	Change Delivery	Final Draft
1.0	02.04.04	Change Delivery	BSC Panel	Final Version

### 10.2 References

Ref	Document	Owner	Issue date	Version
1	P161 Modification Proposal	-	30 January 2004	-
2	P161 Initial Written Assessment	ELEXON	6 February 2004	1.0
3	P161 Consultation Document	ELEXON	10 March 2004	1.0
4	"The New Electricity Trading Arrangements: Volume 1"	Ofgem/DTI	July 1999	-
5	"The New Electricity Trading Arrangements: Ofgem/DTI Conclusions Document"	Ofgem/DTI	October 1999	-
6	"ELEXON's Business Strategy and Annual Budget 1 April 2004 – 31 March 2007"	ELEXON	-	-
7	"Review of the Role and Effectiveness of non-Executive Directors" (Derek Higgs)	DTI	January 2003	-
8	"The Combined Code on Corporate Governance"	The Financial Reporting Council	July 2003	-

## ANNEX 1 DRAFT LEGAL TEXT

See separate attachment

## ANNEX 2 MODIFICATION GROUP DETAILS

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

Name	Organisation (Role)	Member	Meeting Attendance		
			19/02/04	02/03/04	24/03/04
David Warner	ELEXON (Chairman)	Y	Y	Y	Y
Roger Salomone	ELEXON (Lead Analyst)	Y	Y	Y	Y
Kevin Rendell	NGT	Y	Y	N	Y
James Nixon	Scottish Power	Y	Y	Y	Y
Joanne Ellis	Cornwall Consulting	Y	Y	Y	Y
John Sykes	Scottish & Southern	Y	N	N	N
Mark Manley	BGT	Y	Y	Y	Y
Neil Smith	Powergen	Y	Y	Y	Y
Terry Ballard	Innogy	Y	Y	N	Y
Jerome Williams	Ofgem	N	Y	Y	Y
Gareth Forrester	ELEXON	N	Y	N	Y
David Ahmad	ELEXON	N	Y	N	N

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

- David Warner and Roger Salomone were GSMG members, acting 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 the Board and its Directors. Gareth Forrester, manager of ELEXON's Governance and Regulatory Affairs team, was present to present and explain the SBH report's recommendations.

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.

The Panel made the following additions to the standard Assessment Procedure 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.

### ANNEX 3 CONSULTATION RESPONSES

See separate attachment

### ANNEX 4 CLARIFICATION OF COSTS

There are several different types of costs relating to the implementation of Modification Proposals. ELEXON implements the majority of Approved Modifications under its CVA or SVA Release Programmes. These Programmes incur a base overhead which is broadly stable whatever the content of the Release. On top of this each Approved Modification incurs an incremental implementation cost. In order to give Stakeholders a feel for the estimated cost of implementing an Approved Modification the templates shown in Attachment 1 have three columns:

- **Stand Alone Cost** – the cost of delivering the Modification as a stand alone project outside of a CVA or SVA Release, or the cost of a CVA or SVA Release with no other changes included in the Release scope. This is the estimated maximum cost that could be attributed to any one Modification implementation.
- **Incremental Cost** - the cost of adding that Modification Proposal to the scope of an existing release. This cost would also represent the potential saving if the Modification Proposal was to be removed from the scope of a release before development had started.
- **Tolerance** – the predicted limits of how certain the cost estimates included in the template are. The tolerance will be dependent on the complexity and certainty of the solution and the time allowed for the provision of an impact assessment by the Service Provider(s).

The cost breakdowns are shown below:

PROGRESSING MODIFICATION PROPOSAL	
<b>Demand Led Cost</b>	This is the third party cost of progressing a Modification Proposal through the Modification Procedures in accordance with Section F of the Code. Service Provider Impact Assessments are covered by a contractual charge and so the Demand Led cost will typically be zero unless external legal assistance or external consultancy is required.

<b>ELEXON Resource</b>	This is the ELEXON Resource requirement to progress the Modification Proposal through the Modification Procedures. This is estimated using a standard formula based on the length of the Modification Procedures.
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<b>SERVICE PROVIDER<sup>19</sup> COSTS</b>	
<b>Change Specific Cost</b>	Cost of the Service Provider(s) Systems development and other activities relating specifically to the Modification Proposal.
<b>Release Cost</b>	Fixed cost associated with the development of the Service Provider(s) Systems as part of a release. This cost encompasses all the activities that would be undertaken regardless of the number or complexity of changes in the scope of a release. These activities include Project Management, the production of testing and deployment specifications and reports and various other standard release activities.
<b>Incremental Release Cost</b>	Additional costs on top of base Release Costs for delivering the specific Modification Proposal. For instance, the production of a Test Strategy and Test Report requires a certain amount of effort regardless of the number of changes to be tested, but the addition of a specific Modification Proposal may increase the scope of the Test Strategy and Test Report and hence incur additional costs.

<b>IMPLEMENTATION COSTS</b>	
<b>External Audit</b>	Allowance for the cost of external audit of the delivery of the release. For CVA BSC Systems Releases this is typically estimated as 8% of the total Service Provider Costs, with a tolerance of +/- 20%. At present the SVA Programme does not use an external auditor, so there is no External Audit cost associated with an SVA BSC Systems Release.
<b>Design Clarifications</b>	Allowance to cover the potential cost of making any amendments to the proposed solution to clarify any ambiguities identified during implementation. This is typically estimated as 5% of the total Service Provider Costs, with a tolerance of +/- 100%.
<b>Additional Resource Costs</b>	<p>Any short-term resource requirements in addition to the ELEXON resource available. For CVA BSC Systems Releases, this is typically only necessary if the proposed solution for a Modification Proposal would require more extensive testing than normal, procurements or 'in-house' development.</p> <p>For SVA BSC Systems Releases, this will include the management and operation of the Acceptance Testing and the associated testing environment.</p> <p>This cost relates solely to the short-term employment of contract staff to assist in the implementation of the release.</p>

<sup>19</sup> A Service Provider can be a BSC Agent or a non-BSC Agent, which provides a service or software as part of the BSC and BSC Agent Systems. The Service Provider cost will be the sum of the costs for all Service Providers who are impacted by the release.

<b>Additional Testing and Audit Support Costs</b>	Allowance for external assistance from the Service Provider(s) with testing, test environment and audit activities. Includes such activities as the creation of test environments and the operation of the Participant Test Service (PTS). For CVA BSC Systems Releases, this is typically estimated as £40k per release with at tolerance of +/-25%. For SVA BSC Systems Releases this is estimated on a Modification Proposal basis.
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### TOTAL DEMAND LED IMPLEMENTATION COSTS

This is calculated as the sum of the total Service Provider(s) Cost and the total Implementation Cost. The tolerance associated with the Total Demand Led Implementation Cost is calculated as the weighted average of the individual Service Provider(s) Costs and Implementation Costs tolerances. This tolerance will be rounded to the nearest 5%.

### ELEXON IMPLEMENTATION RESOURCE COSTS

Cost quoted in man days multiplied by project average daily rate, which represents the resources utilised by ELEXON in supporting the implementation of the release. This cost is typically funded from the "ELEXON Operational" budget using existing staff, but there may be instances where the total resources required to deliver a release exceeds the level of available ELEXON resources, in which case additional Demand Led Resources will be required.

The ELEXON Implementation Resource Cost will typically have a tolerance of +/- 5% associated with it.

### ONGOING SUPPORT AND MAINTENANCE COSTS

<b>ELEXON Operational Cost</b>	Cost, in man days per annum multiplied by project average daily rate, of operating the revised systems and processes post implementation.
<b>Service Provider Operation Cost</b>	Cost in £ per annum payable to the Service Provider(s) to cover staffing requirements, software or hardware licensing fees, communications charges or any hardware storage fees associated with the ongoing operation of the revised systems and processes.
<b>Service Provider Maintenance Cost</b>	Cost quoted in £ per annum payable to the Service Provider(s) to cover the maintenance of the amended BSC Systems.

## ANNEX 5 PROPOSED TEXT TO MODIFY BSCCO MEMORANDUM AND ARTICLES OF ASSOCIATION

To implement P161, the following changes to BSCCo's Articles of Association would be required:

### 18. Number of Directors

Unless otherwise determined by ordinary resolution, the number of directors shall not be greater than ~~five~~ **seven** and the minimum number of directors shall be one.

## 26. Majority shareholders' right to appoint and remove directors

Any member or members holding a majority in nominal amount of the issued ordinary share capital which confers the right to attend and vote at general meetings may at any time appoint any person to be a director, whether as an additional director or to fill a vacancy, and may remove from office any director howsoever appointed provided that no such appointment or removal shall take effect unless it ~~has first been approved in accordance with the Code~~ is in accordance with the provisions of the Code. Any such appointment or removal shall be effected by notice in writing to the Company signed by the member or members making the same or in the case of a corporate member signed by any director thereof or by any person so authorised by resolution of the directors or of any other governing body thereof. Any such appointment or removal shall take effect when the notice effecting the same is delivered to the registered office or to the secretary of the Company, or is produced at a meeting of the directors. Any such removal shall be without prejudice to any claim which a director may have under any contract between him and the Company.

## ANNEX 6 EXTRACTS FROM SAXTON BAMFYLDE 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 (e.g. 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 7 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**