

# P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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## BACKGROUND

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ELEXON Limited ("ELEXON") is a not-for-profit unconsolidated subsidiary of National Grid, and as such has only one shareholder who, because of constraints set out in the BSC, cannot act in the same way as a normal shareholder, for example, removing Directors etc. Further to this, as a not-for-profit limited company all costs for the operation of BSC services are recovered from BSC Parties through Section D charges.

Early in 2013, the BSCCo Board and BSC Panel jointly commissioned an independent review of BSC governance, the scope of which was to "consider the governance of ELEXON with regard to the confines of the BSC, particularly in the light of discussions over recent years in relation to changes to BSCCo's vires". They appointed former Council of Lloyd's deputy chairman Bill Knight to undertake the review and his report was published in July 2013.

Based on the conclusions of the Knight Report, two Modifications were raised to address issues with the Code's governance model and to allow the BSCCo Board to comply with good corporate governance, as set out in the [UK Corporate Governance Code](#):

[P325 'Improving the accountability of BSCCo to stakeholders and better aligning BSCCo governance with best practice'](#) was raised by SSE Energy Supply Ltd on 30 July 2015. It followed National Grid raising [P324 'Review of BSCCo's governance: introducing improved accountability to BSC Parties'](#) on 24 July 2015. Both Modifications sought to progress reforms to ELEXON's governance following the conclusions of the Knight Report.

A key aspect of both Modifications is the increased accountability of the BSCCo Board to the BSC Parties that fund ELEXON, and both Modifications put in place the provision for Trading Parties and Distribution Businesses to be able to raise and vote on resolutions, including the removal of a Director from the Board.

P324 sought to implement this aspect through creating the concept of a 'Voting Party' (a group of affiliated Trading Parties and Distribution Businesses) and allocating votes to these entities. Votes were allocated to Trading Party Groups proportionate to their market share (subject to a cap), with further votes allocated equally across Distribution Businesses. However, the ownership of BSCCo remained unchanged, with National Grid as ELEXON's sole shareholder. Furthermore, P324 did not propose to amend ELEXON's vires. P324 was implemented on 11 November 2016.

P325 had a different focus for addressing the accountability issue. The original P325 Modification Proposal sought to make the ELEXON Board accountable to 'Interested Parties' by making BSC Parties shareholders of ELEXON. Following the approval and implementation of P324, the P325 Proposer varied the proposed solution so that P325 no longer involved transferring the ownership of ELEXON from National Grid to BSC Parties.

Since P325 was raised, a number of the issues originally identified in the P325 Modification Proposal have, to a large degree, been achieved through the implementation of P324. In particular, the rules relating to the BSCCo Board have been amended so that it is now able to comply with the UK Corporate Governance Code and inefficiencies in BSC decision making processes have been resolved. In addition, accountability to BSC Parties has been achieved by (i) allowing those parties to remove BSCCo's Directors and (ii) for BSC Parties to vote on the re-appointment of Directors (in a process that mirrors the re-election of directors followed by public companies).

The subsequent discussions in the Workgroup have concentrated on whether to amend the current provisions in BSC Section C to permit ELEXON to undertake roles and activities outside the BSC. Under the current arrangements, ELEXON can only undertake activities that fall outside the scope of the BSC if those activities are approved by a Modification (whether following the BSC Modification Procedures or directed by the Secretary of State using statutory powers).

The P325 Workgroup has considered how ELEXON could seek funding for non-BSC activities, with the key underlying principles being:

- no BSC Parties should be obliged to fund the bid and set-up costs of non-BSC activities; and
- should ELEXON decide to seek investment, all BSC Parties should have an equal opportunity to invest in any such opportunities.

# P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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## How has P325 changed?

The accountability and governance arrangements proposed in the original solution for P325, were addressed by the implementation of P324.

P324 amended the BSC accountability and governance arrangements:

- To allow the Board to set BSCCo's Business Strategy
- To make the Board fully responsible for appointing its own directors and chairman
- To make the BSCCo Board accountable to Voting Parties by allowing them to vote to approve the appointment of Directors, and to remove Directors
- To allow ELEXON to appoint executive directors, therefore making the Chief Executive accountable to BSC Parties; and
- To allow the remuneration of all Non-Executive Directors

The outstanding considerations under P325 are whether ELEXON should be allowed to undertake other activities and the Modification contemplates potential changes to ELEXON's funding. However, the solution no longer contemplates changes to ELEXON's ownership. National Grid will remain the sole shareholder.

## PROPOSED SOLUTION

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### Main Principles

1. BSC Parties should be under no obligation to fund the costs involved in ELEXON bidding for and/or setting up and/or operating new business opportunities.
2. ELEXON will, however, be entitled to include a scoping fund as part of its annual budget. This budget will be a BSC Cost and may be used to investigate opportunities and develop investment proposals through to their cancellation or to agreement being reached that the proposal should be funded.
3. If ELEXON has identified a new business opportunity, all BSC Parties should be afforded an equal opportunity to invest.
4. Subject to the key principles, ELEXON should be able to operate the P325 procedures flexibly to ensure that it is able to respond to business opportunities within constrained timescales

### Detailed Requirements

#### 1. There will be no restriction of affiliates of ELEXON undertaking non-BSC activities

Whilst the restriction on ELEXON undertaking non-BSC activities will remain, that restriction will no longer apply to ELEXON affiliates (subject to the further details of these requirements).

#### 2. Other than as set out in Requirement 8, ELEXON will not be permitted to fund non-BSC activities

## P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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Section D charges will continue to be used to fund only those activities contemplated in the BSC. Other than as set out in requirement 8, ELEXON will not be permitted to fund non-BSC activities.

### **3. Business Strategy and Annual Budget may include 'scoping activities' and a 'scoping fund'**

For each BSC Year ELEXON will set a Business Strategy and Annual Budget in accordance with the current BSC process.

However, the Business Strategy may cover the investigation of non-BSC activities that ELEXON anticipates arising during the forthcoming BSC Year ("scoping activities"). The investigation of these activities will be funded by a scoping fund which ELEXON will include in its Annual Budget.

The scoping activities and the scoping fund will be subject to industry comment as part of the Business Strategy and Annual Budget.

If ELEXON adopts a Business Strategy and Annual Budget which Parties disagree with then the usual remedies of raising and passing a non-binding resolution (to register disapproval) or a binding resolution (to remove a director or the board) will be open to BSC Parties. The process for these resolutions will be the process that was introduced through P324.

The scoping fund will be a BSC Cost, recoverable from all BSC Parties in accordance with Section D of the Code.

### **4. ELEXON will be able to use the scoping fund to cover costs incurred in developing new opportunities**

The scoping fund may be used by ELEXON to cover all of its (internal and third party) costs incurred in investigating and developing an opportunity through to the point of securing an agreement with BSC Parties and, potentially, third parties, pursuant to which they agree to fund a new activity. Such activities might include:

- (a) Investigating opportunities to provide non-BSC services;
- (b) Developing opportunities through to the point where an investment proposal can be circulated to Parties. In the context of a competitive procurement, the scoping fund would cover the cost of ELEXON submitting a PQQ response but not submitting a tender;
- (c) Developing investment proposals in sufficient detail that BSC Parties and, potentially, third parties can decide whether or not to invest;
- (d) Documenting an agreement between Funding Parties that allows an ELEXON affiliate to proceed with an opportunity with funding secured. This could include, for example, the cost of developing and negotiating a shareholder agreement (if BSC Parties are providing equity investment) or a loan agreement (if the new opportunity is to be funded by debt). The BSC will not stipulate what type of agreement should be concluded pursuant to (d) – this will depend on the funding model adopted and shall be subject to agreement between the ELEXON affiliate and the Funding Parties.

The Scoping Fund may not be used to fund bid costs, set-up costs or the operational costs of a new non-BSC activity.

### **5. Once ELEXON has developed a new business opportunity which it wishes to pursue, it must seek funding from all BSC Parties**

ELEXON must prepare and send to all BSC Parties an investment proposal including such information that it feels is sufficient to allow BSC Parties to make an investment decision, including the following:

- (a) The investment sought

## P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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- (b) Details of the operating model
- (c) Projected profitability
- (d) Payback mechanism
- (e) Whether a third party is involved in the proposal and, if so, an explanation of their interest
- (f) In those circumstances described in Requirement 10, the investment proposal should also include details on the terms of acceptance to invest, as well as a form of acceptance document by which BSC Parties may communicate to ELEXON their agreement to invest.

The investment proposal should explain the consequences of two possible scenarios:

- (a) If all BSC Parties agree to invest, that the activity will be funded through the BSC by way of Section D charges;
- (b) If less than all BSC Parties agree to invest, that the activity will be funded outside the BSC.

These are likely to involve different operating models and payback mechanisms (and potentially the projected profitability).

### **6. ELEXON must determine whether to proceed with a vote of all BSC Parties**

In order for ELEXON to seek funding for a non-BSC activity it must first determine whether to hold a vote of all BSC Parties. This mechanism will determine only whether a new activity can be funded through the BSC by way of Section D charges. However, ELEXON need not proceed with a vote where it is clear to ELEXON that the proposal will not achieve the requisite unanimous support. In this case, ELEXON may proceed straight to the steps described in Requirement 10

### **7. Optional - Conducting a vote on a potential new activity**

If ELEXON proposes to organise a vote on a potential new activity, the voting mechanism will be as follows:

- (a) ELEXON will propose a resolution describing the new activity and including the investment proposal as described in paragraph 5;
- (b) In order to propose a resolution, ELEXON may either circulate the resolution in writing or send out notice for a general meeting;
- (c) The notice/resolution must be sent to all parties which are entitled to vote on a resolution to allow ELEXON to undertake new activities.
- (d) If conducted by correspondence then ELEXON will set a deadline for responses to be received. The deadline must be no less than 14 clear days from the circulation date of the notice.
- (e) If conducted by general meeting, the P324 procedural rules will apply other than the minimum notice period for a general meeting should be reduced to 14 clear days.
- (f) All BSC Parties will have one vote;
- (g) In order for the resolution to be passed, 100% of votes cast need to approve the resolution. Only votes in favour or against will be counted. Abstentions and uncast votes will not be counted.
- (h) For any vote, whether by correspondence or general meeting a quorum needs to be achieved. The quorum should be determined using the P324 mechanism.
- (i) ELEXON will announce the outcome in line with P324 timescales.

## P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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### **8. If all BSC Parties approve the funding of the proposed new activity in accordance with the voting mechanism described in paragraph 6 then all of the costs incurred in pursuing, developing and establishing that opportunity will be BSC Costs**

If all BSC Parties agree to invest in an investment proposal then the costs incurred by Elexon in pursuing, developing and establishing that opportunity may be charged by ELEXON to all BSC Parties in accordance with Section D Charges rules as BSC Costs. ELEXON will need to amend its Business Strategy and Annual Budget for the then current year in order to reflect the additional activity and costs that will be funded through BSCCo Charges.

### **9. Implementation of new activity for which the funding has been approved by all BSC Parties through the voting mechanism described in paragraph 6**

The steps for implementation of the new activity will have been set out in the investment proposal prepared pursuant to paragraph 5. The principles behind the implementation should be:

- New activities should be pursued through an ELEXON 'affiliate' (see further requirements in paragraph 11);
- ELEXON itself should not make a profit from the new activity (without prejudice to any defrayment of BSC costs or any separate payback mechanism put in place between the affiliate and BSC Parties)

### **10. If a resolution is not adopted by all BSC Parties to fund a new activity through Section D charges, or if ELEXON does not believe that a vote will be successful, then ELEXON may seek funding outside of the BSC**

If a resolution is not adopted by all BSC Parties, or if ELEXON does not believe that a vote will be successful, then ELEXON may in its sole discretion seek investment from individual BSC Parties on a separate basis, or from non-BSC Parties. This will be subject to the following:

- a) If no vote has been taken, all BSC Parties must be given an opportunity to invest on the basis of the investment proposal. In this case, ELEXON's investment proposal will include the details referred to in Requirement 5(f).
- b) If a vote has been taken then ELEXON need only approach those BSC Parties who voted in favour of the new activity. In this case, ELEXON will issue an update investment proposal including the details referred to in Requirement 5(f).
- c) ELEXON may seek funding from non-BSC Parties provided either that (i) ELEXON has notified all BSC Parties that it is seeking funding from non-BSC Parties; and/or (ii) BSC Parties have also been invited to provide funding for the new activity.

Other than as set out in Requirement 11, the requirements of any such funding mechanism will fall outside the scope of the BSC.

### **11. ELEXON relationship with affiliate(s) which provide non-BSC activities**

New activities may not be undertaken by ELEXON (unless approved by a vote pursuant to paragraph 6.).

It is expected that new activities will be performed by an affiliate (or affiliates) but the Code will not mandate the legal form of new activities.

Unless approved under paragraph 6, the protections contained in paragraphs C3.4, C3.5 and C10.2 should apply to all new activities. ELEXON will be entitled to provide resource to affiliates/new activities on an arms-length basis. If funding is approved by all BSC Parties then some of these restrictions can be relaxed e.g. to reflect that ELEXON is providing funding to the affiliate.

## P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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The general restrictions in the Code that prevent ELEXON undertaking other business should be removed e.g. as per C10.1.1(a), (c), (d), 10.1.2 – 10.1.4 + 10.1.6 .

There will be no restriction on affiliates undertaking new activities for profit. ELEXON, however, will not be entitled to make a return from those activities (e.g. no dividend or interest other than repayments).

All BSC Parties will be entitled to benefit from non-BSC activities to the extent that ELEXON can defray its costs through the performance of new activities.

### FURTHER QUESTIONS

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1. How should the Scoping Fund be framed in the BSC? As drafted it covers all costs up to (and including) ELEXON securing funding for a new opportunity. However:
  - a. Will ELEXON be entitled to commence any work on a tender under this budget? In particular, if ELEXON cannot start working on a tender before it has secured funding for its Bid Costs then there will be a much risk that costs incurred in seeking funding from BSC Parties/third parties will be lost i.e. by the time ELEXON has secured funding there will be no time to prepare and submit a bid.
  - b. The solution currently seeks to restrict the use of the Scoping Fund by being clear about what categories of spend the fund can and can't be used for. However, provided the spending falls within an approved category the Requirements do not explicitly include controls on how the Scoping Fund may be spent, though obviously ELEXON has internal controls which would ultimately be enforced by a P324 vote. Is that correct or should there be a restriction on the amount of cost ELEXON can incur in, for example, seeking funding from third parties?
2. Is the voting mechanism in Requirement 7 necessary? As we understand it, the intention of this element of the solution is that:
  - a. all BSC Parties should be entitled to participate, or refuse to participate, in every investment proposal; and
  - b. if all BSC Parties agree to fund an investment proposal then the funding mechanism will be the BSCCo charging mechanism described in Section D charges.

This outcome can be achieved, however, without a vote. Requirement 10 could state that every investment proposal must be sent to all BSC Parties, rather than just those who have voted favourably. If all BSC Parties who respond are in favour (subject to a de minimis response level) then the investment proposal would be funded through Section D charges. If the response is divided then ELEXON will engage with those Parties in favour of the proposal as envisaged in Requirement 10. This would be more efficient both for ELEXON and for interested Parties.

3. Under Requirement 7 (the voting mechanism), if this Requirement is still deemed to be necessary, please confirm:
  - a. Is 14 clear days is an appropriate notice period in 7(d) and (e)? (14 clear days is shortest notice period a company can give for a general meeting)
  - b. Is it correct for the voting to be decided on a one Party, one vote basis? The rationale for this is that a vote must be unanimous for the decision to be carried (in effect for an investment to be funded through Section D charges) so there is no need for a funding share based vote – everyone has a veto.
  - c. Are we right to only count votes in favour or against – abstentions and non-votes being discounted?
  - d. Is it appropriate to use the P324 quorum requirements even though we are not using the P324 voting mechanism? If not this, then what should be the quorum requirements?

## P325 - DRAFT REQUIREMENTS FOR LEGAL TEXT

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- e. Should there be a right to request an audit as per P324?
- 4. It is understood that the solution requires all BSC Parties to be given the opportunity to invest in a proposal:
  - a. Please confirm this is correct rather than, for example, all Trading Parties?
  - b. Do BSC Parties need to be given the opportunity to provide 100% of the funding?
  - c. Does this mean that there should be a restrictions on an ELEXON affiliate undertaking a BSC activity if no funding is needed by that affiliate? For example, the affiliate may be able to re-invest profits, including into other activities that have not been offered to BSC Parties? Alternatively, third party funding may be available.
  - d. Can we be flexible about how we frame this in the BSC? For example, the rationale for establishing an affiliate is to create a ring fence between ELEXON (not-for-profit/BSC only) and affiliates (potentially profit making non-BSC activities). It would, however, be inefficient to establish a separate affiliate for each new activity if the same outcome could be achieved through a single affiliate.
- 5. We will need to clarify the circumstances in which ELEXON can seek funding from third parties. Does this need to form part of ELEXON's investment proposal or can ELEXON seek third party funding if it cannot achieve its funding needs from BSC Parties.

### FURTHER COMMENTS

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- 1. The Requirements assume that ELEXON continues to be not-for-profit but that it can have profit making affiliates. The dividend policy of that affiliate will be a matter to be determined between the affiliate and its shareholders. There will be no restriction, however, on the affiliate retaining profits.
- 2. Under Requirement 11, we assume that the ring fencing protections that already apply to 'Permitted Affiliates' (e.g EMRS) should apply to any other affiliates undertaking non-BSC activities.