

Modification proposal:	<b>Balancing and Settlement Code (BSC) P281: Change of BSCCo Board of Directors &amp; Chairman (P281)</b>		
Decision:	The Authority <sup>1</sup> directs that the Alternative proposal be made <sup>2</sup>		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	17 September 2012	Implementation Date:	10 working days after publication

## Background to the modification proposal

The New Electricity Trading Arrangements (NETA) came into force in 2001, superseding the Pooling and Settlement Agreement and establishing new rules for electricity trading. These rules were incorporated into the Balancing and Settlement Code (BSC). The BSC sets out the powers, functions and constitution of the Balancing and Settlement Code Company (BSCCo), a non-profit-making company established to facilitate the effective delivery, implementation, operation and development of the electricity trading arrangements.<sup>3</sup>

The BSCCo Board's role includes approving the annual budget, monitoring performance, and ensuring that BSCCo operations are subject to effective cost control. The BSCCo's trading activities are restricted by BSC Section C1.2.2, which precludes it from undertaking any business or activity which is not provided for in the BSC itself.

The current arrangements for the BSCCo Board were determined by Ofgem and the Department of Trade and Industry (DTI) following consultations on NETA.<sup>4</sup> The Board comprises five directors: an independent Chairman; two 'industry' directors who are also BSC Panel members (elected to the Board by the Panel); and two additional directors<sup>5</sup> who are nominated by the Chairman in consultation with the Panel. All directors are non-executive and serve for an initial term of two years, with the exception of the Chairman who serves for three years.<sup>6</sup>

## The modification proposal

Modification proposal P281 seeks to change the make-up and appointment process of the BSCCo's Board in order to allow BSC parties (who fund the BSC arrangements) to have a more active say in the management and oversight of the BSCCo. The proposal also seeks to ensure that there is separation of the BSCCo Board from the management of Elexon, in the event that Elexon is permitted to diversify its trading activities.<sup>7</sup> The proposer, E.ON Energy Solutions Ltd, believes that the current arrangements allow for non-industry directors, together with the Chairman, to carry decisions against the will of the industry directors, which might result in decisions being made that are not in the interests of BSC Parties.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

<sup>3</sup> The BSCCo is Elexon Ltd (or any successor to that company acting in the capacity as BSCCo), as defined in Annex X-1 of the BSC.

<sup>4</sup> <http://www.ofgem.gov.uk/Licensing/ad/Documents1/The%20New%20Electricity%20Trading%20Arrangements%2029%2010.pdf>

<sup>5</sup> BSC Section C 4.1.1. (c). The additional directors may be selected from the Panel or from outside the Panel.

<sup>6</sup> The current BSCCo Chairperson was appointed by Ofgem. Future appointments are to be made in accordance with Condition C3 1(f)(i) of the electricity transmission licence and subject to Authority approval.

<sup>7</sup> Modification proposal P284 seeks to enable the BSCCo to outsource some of all of the BSC services, currently delivered by Elexon, and separate the BSCCo from 'New Elexon'. See also Ofgem's open letter, April 2012: <http://www.ofgem.gov.uk/Licensing/IndCodes/Governance/Documents1/elexon%20expansion%20way%20forward%20letter%20300412.pdf>.

The original proposal (“P281 Proposed”) splits BSC Parties into four constituencies – Large Suppliers, Small Suppliers, Large Generators, and Small Generators – and proposes that each constituency would vote to elect one member to the BSCCo Board. An independent Chairman would also serve on the Board. The proposer considers that this would safeguard the interests of BSC Parties from any potential risk or conflict of interest that may arise should Elexon be permitted to undertake non-BSC commercial activities. Under this proposal, the directors would serve on the Board for three years and their position would be subject to re-election.

The alternative proposal (“P281 Alternative”) is that a Nomination Committee would be empowered to determine the required size of the BSCCo Board and select candidates for appointment, subject to Terms of Reference approved by the BSC Panel. The BSC Panel would have the ability to veto appointments in the event that those Terms of Reference had not been followed. The Nomination Committee would be made up of the Board Chairman, one ‘industry’ director and one ‘industry-independent’<sup>8</sup> director, with the provision for the BSC Panel to appoint an advisor to the Committee. This proposal prescribes that a minimum of two ‘industry-independent’ directors are appointed to the Board and that the majority of Board members (excluding the Chairman) shall have ‘relevant electricity industry experience’. The directors would serve for an initial term of two years in line with the present arrangements. P281 Alternative aims to reflect current best practice in corporate governance and incorporate Party input and Panel oversight.

Under both proposals, Panel and Board membership are distinct, with the exception of the BSC Panel Chairman who must also be the BSCCo Chairman.<sup>9</sup> P281 does not seek to amend any of the functions of the BSCCo Board or deal with the process for the Panel to appoint a Chairman,<sup>10</sup> nor does it set out arrangements for director remuneration.

### **BSC Panel<sup>11</sup> recommendation**

On 9 August 2012, the BSC Panel held its final discussions on the original proposal and the alternative. The Panel recommended to the Authority that P281 Proposed should not be approved as it would not further the relevant BSC objectives. The Panel recommended that P281 Alternative should be approved as it would further BSC objective (d). A minority of the Panel felt that the Alternative would be detrimental to objective (d), by increasing complexity and reducing transparency in the Board election process.

### **The Authority’s decision**

We have considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 10 August 2012. We have considered and taken into account the responses to Elexon’s<sup>12</sup> consultation which are attached to the FMR.<sup>13</sup> We have concluded that:

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<sup>8</sup> Under this proposal ‘industry-independent’ means where the individual (or a ‘related person’ to that individual) has not in the five years prior to their appointment been a Panel Member; employee, director or representative of any BSC Party or class of Parties; or any BSC Agent or agent of the BSCCo.

<sup>9</sup> In accordance with BSC Section C 4.1.1. (a)

<sup>10</sup> P281 legal text includes a housekeeping amendment to reflect changes to the transmission licence requiring the licensee to appoint an independent panel chair.

<sup>11</sup> The BSC Panel is established and constituted pursuant to and in accordance with Section B of the BSC.

<sup>12</sup> The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.

<sup>13</sup> BSC modification proposals, modification reports and representations can be viewed on the Elexon website at [www.elexon.com](http://www.elexon.com)

1. implementation of P281 Proposed will not better facilitate the achievement of the relevant objectives of the BSC;<sup>14</sup>
2. implementation of P281 Alternative will better facilitate the achievement of the relevant objectives of the BSC;<sup>15</sup> and
3. directing that the Alternative modification be made is consistent with the Authority's principal objective and statutory duties.<sup>16</sup>

## Reasons for the Authority's decision

### P281 Proposed

The election process set out by P281 is intended to ensure that the Board is made up of directors who have relevant experience and an understanding of how decisions made by the BSCCo will affect BSC Parties. The proposal does not envisage that the elected Board members should be 'representatives' of their consistency. The workgroup and some consultation respondents were however concerned that election by constituency would imply representation of that particular group and that this would not be an effective process to appoint Board members that are required to act independently. Other respondents, however, felt that the BSCCo was sufficiently unique to warrant the arrangements described in P281 Proposed.

Our view is that these arrangements may not be conducive to forming an effective Board, with an optimum balance of skills and experience, as they are highly prescriptive as to the Board's composition. The pool of candidates for election would be strictly limited and the ability to appoint directors from outside the electricity industry would be removed. P281 Proposed also excludes BSC Parties who are neither Suppliers nor Generators from the Board election process; we recognise that Suppliers and Generators predominately fund the BSC, however the BSCCo Board must represent all BSC stakeholders.

One respondent commented that the Proposed modification was preferable to the Alternative because, in the event that proposed structural change to the BSCCo were to take place, the BSCCo might be reduced to a skeleton staff. In this eventuality they considered that Parties would need a strong Board capable of understanding the detailed operational and commercial aspects of the BSC. We note this point. However, it is not clear to us, to the extent this would be required, that P281 Proposed is more capable of delivering such a Board than either the status quo or P281 Alternative.

For the reasons set out above, we do not agree that this proposal sets out appropriate criteria for ensuring an effective Board and therefore consider it would not better achieve relevant objective (d):

*Objective d) - "Promoting efficiency in the implementation and administration of the balancing and settlement arrangements"*

However, we support those elements of the proposal that seek to increase BSC Party engagement in the election process and to remove the restriction on two BSCCo Board members being necessarily drawn from the BSC Panel.

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<sup>14</sup> As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: <http://epr.ofgem.gov.uk/index.php?pk=folder380751>

<sup>15</sup> As set out in Standard Condition C3(3) of NGET's Transmission Licence, see: <http://epr.ofgem.gov.uk/index.php?pk=folder380751>

<sup>16</sup> The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989.

### P281 Alternative

We consider that P281 Alternative better facilitates relevant objective (d) and is neutral in relation to objectives (a) (b) (c) and (e).

P281 Alternative aims to reflect accepted UK corporate governance standards which require a formal, rigorous and transparent process for Board appointments.<sup>17</sup> P281 Alternative broadens the pool of candidates from which the BSCCo Board may be drawn and enables BSC Parties to have increased engagement in the election process compared to the baseline. We consider that this will ensure a more robust Board which can further ensure efficiency in the BSC arrangements.

P281 Alternative makes provision for 'industry-independent' Directors to be appointed to the Board. We consider that directors who are independent of industry can bring benefits to the Board such as specific skills and an impartial perspective on stakeholder needs. We do not consider it essential to codify this arrangement, as this could have been dealt with by the Terms of Reference as a matter of best practice and allowing for the specific needs of the Board to be taken into account. However, we are nonetheless content that this is an improvement on P281 Proposed.

The alternative proposal allows for an unlimited number of Board members. In principle, we agree that there should be flexibility for the Board to vary its size according to its requirements, provided that it does not become so unwieldy as to be ineffective; we note from the FMR that the Nomination Committee's Terms of Reference should be effective in dealing with this point. We remain of the view that the Board should be smaller in size than the Panel and that in light of the highly limited nature of the BSCCo Board's activities, the current size remains broadly fit for purpose.

P281 Alternative highlights that the key principles of P281 Proposed were increasing the influence of BSC Parties on the constitution of the Board and increasing the Board's transparency and accountability to them. Unlike P281 Proposed, P281 Alternative does not make provision BSC Parties to vote candidates onto the BSCCo Board; rather, it is a matter for a Committee of the Board to determine the appointments.

However, the BSC Panel retains control over the Nomination Committee's Terms of Reference ensuring that the Panel, which represents BSC Parties, maintains oversight of the appointments. BSC Parties could be given the ability to submit candidates for election, if this is set out under the Terms of Reference.

There were mixed views from consultation respondents on whether this approach increases industry participation in the Board arrangements compared to the status quo. One respondent who did not support the Alternative noted that it could potentially reduce the influence of BSC Parties, who are the main stakeholders. One respondent noted that the BSCCo was essentially a 'monopoly' service provider and that BSC Parties therefore did not have the ability to obtain these services elsewhere.

One respondent who supported the implementation of the Alternative, however, felt that P281 Alternative provided for a minimum level of industry experience on the Board and a role for industry in the establishment and oversight of the selection process, thus allowing greater confidence in the constitution and operation of the BSCCo Board.

The Workgroup expressed some concern that the Nomination Committee might not be transparent, and one respondent to the consultation was concerned that the process

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<sup>17</sup> FRC UK Corporate Governance Code, Principle B2 <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Corporate-Governance-Code.aspx>

outlined appeared to be vague. We consider that an open and transparent process is a key benefit of this modification and that it is the responsibility of the BSC Panel to ensure this by way of the Terms of Reference. We expect the Panel to ensure that the Terms of Reference will make provision for an appropriate level of BSC Party engagement, ensure that the Board are held properly to account at all stages of the process, and specify that no director should be present at a Committee meeting where their own reappointment is discussed. The presence of a Panel advisor to the Committee should help to ensure the robustness of this process.

One area that we consider P281 Alternative could have explored more fully is the Board's accountability to Parties. There is no provision for Parties, either directly or via the Panel, to remove directors who are ineffective. The Panel is able to question the Board and Nomination Committee about the candidates and selection process at the annual BSC meeting. However, the Panel can only veto an appointment on the basis that this was not made in line with the Terms of Reference (or otherwise approved by the Panel). A two-thirds majority vote of the Panel is required in order to veto an appointment although it is not clear how this threshold was determined or why it was selected over a simple majority.

We also note that the Alternative proposal does not address the Proposer's original concern about BSC Party representation on the Panel; under the Alternative, it is not necessary for any of the Directors to be Party to the BSC. However, we consider this is also a matter for the Terms of Reference to deal with appropriately. We remain of the view, as set out in Ofgem/DTI Conclusions in respect of NETA, that the presence of non-executive directors who are also BSCCo fee-payers will reassure industry participants that there is sufficient transparency, scrutiny and control of costs.

Whilst we consider that there are areas P281 Alternative could have explored more fully, overall we consider that P281 Alternative increases the transparency of the election process and provides for greater industry engagement when compared to the current arrangements. An open process for Board elections and a robust Board capable of representing all BSC stakeholders will contribute to the achievement of efficiency in the BSC arrangements. Parties are not precluded from raising any further modification if it were felt that further elements of the BSCCo Board arrangements should be codified.

## **Decision notice**

In accordance with Standard Condition C3 of NGET's Transmission Licence, the Authority hereby directs that modification proposal P281: '*Change of BSCCo Board of Directors & Chairman*' (Alternative) be made.

**Andrew Burgess**

**Associate Partner, Transmission and Distribution Policy**

Signed on behalf of the Authority and authorised for that purpose