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The National Grid Company, BSC Signatories and  
Other Interested Parties

23 July 2004

Our Ref: MP No P161

Dear Colleague,

**Modification to the Balancing and Settlement Code (“BSC”) - Decision in relation to  
Modification Proposal P161 “Enhancement of BSCCo Board Structure”.**

The Gas and Electricity Markets Authority (the “Authority”)<sup>1</sup> has carefully considered the issues raised in the Modification Report<sup>2</sup> in respect of Modification Proposal P161, “Enhancement of BSCCo<sup>3</sup> Board Structure”.

The BSC Panel (the “Panel”) recommended to the Authority that Proposed Modification P161 should not be made, but that if the Authority directed that Proposed Modification should be made, the Implementation Date should be 30 Working Days after the Authority’s decision.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives and Ofgem’s wider statutory duties,<sup>4</sup> the Authority has decided not to direct a Modification to the BSC in line with Modification Proposal P161.

This letter explains the background and sets out the Authority’s reasons for its decision, and constitutes notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

**Background**

In May 2003 the BSCCo Board of Directors (the “Board”) commissioned Saxton Bamfylde Hever (“SBH”), a management assessment company, to review the management structure and reporting

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<sup>1</sup> Ofgem is the office of the Authority. The terms “Ofgem” and “the Authority” are used interchangeably in this letter.

<sup>2</sup> ELEXON document reference P161MR, Version No. 1.0, issued 17 May 2004.

<sup>3</sup> Annex X-1 of the BSC defines “BSCCo” as meaning “Elexon Limited (or any successor to that Company acting in the capacity as BSCCo”

<sup>4</sup> Ofgem’s statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

lines of BSCCo. In November 2003, SBH delivered a confidential report which recommended that the Board should, if possible, move to a structure with mixed executive and non-executive membership. The report suggested that two executive members should be added, the chief executive officer and an 'upgraded' chief financial officer. (The report also made further recommendations about the structure of the Board and the senior management of BSCCo).

During the same time as the SBH report was being prepared, the BSCCo separately sought stakeholder views about the performance of BSCCo (via a culture survey). Stakeholder views provided included the view that the Board needed to be closer to the senior BSCCo team, and that the Board could undertake more effective scrutiny of costs in BSCCo.

On 20 January 2004 National Grid Transco (the "Proposer") raised Modification Proposal P161 "Enhancement of BSCCo Board Structure". The Proposal sought to add two new executive positions to the Board; the BSCCo Chief Executive and a senior executive at BSCCo holding a commercially and financially oriented position within the company.

An Initial Written Assessment of the Proposal was considered by the BSC Panel (the "Panel") at its meeting on 12 February 2004. The Panel submitted the Proposal to a two-month Assessment procedure. The Assessment was carried out by the Governance Standing Modification Group (the "GSMG"). The GSMG met three times, and issued a consultation document on 10 March 2004. Eleven responses (representing 52 parties) were provided to this consultation.

The GSMG prepared an Assessment Report which invited the Panel to agree that Modification Proposal P161 should not be made. The Assessment Report was considered at the Panel meeting on 8 April 2004. By a majority, the Panel endorsed the GSMG's recommendation, and agreed to submit the Proposal to the Report Phase.

A draft Modification Report was issued for consultation on 14 April 2004. At the Panel meeting on 13 May 2004 the Panel considered the draft Modification Report and the responses to consultation, and, by a majority, confirmed its initial recommendation that the Modification proposal P161 should not be made.

## **The Modification Proposal**

Modification Proposal P161 seeks to modify the BSC by adding two new Executive Director positions to the Board; the BSCCo Chief Executive, and a senior BSCCo executive holding a commercially and financially oriented position.

The Proposer suggested that this Modification would address stakeholder concerns about the effectiveness of cost control and commercial drivers in BSCCo, which had been voiced in the recent stakeholder survey about the effectiveness of BSCCo. The Proposer also supported the conclusions from the SBH report on the Board structure which recommended that two executive members should be added to the Board. The Proposer believed that this would better facilitate communication between the Board and BSCCo executives and better facilitate 'commercial challenge', ie scrutiny of costs and performance.

The Proposer justified Modification Proposal P161 by stating that it would improve the efficiency of the administration of the Balancing Mechanism and Imbalance Settlement, which

would better facilitate the achievement of Applicable BSC Objective (d)<sup>5</sup>. The Proposer also stated that the Modification would facilitate cost reductions and improvements in BSCCo's efficiency, which would reduce costs to participants and hence reduce barriers to entry. The Proposer believed such reductions would enhance competition in the generation and supply of electricity, and better facilitate achievement of Applicable BSC Objective (c).

The Proposer suggested that the new Executive Directors should have the same rights and obligations as the Industry Directors and Other Directors. The rights of Industry Directors are not identical to the rights of Other Directors, and the Proposer later stated that its intention was that the Executive Directors should have the same rights and obligations as Industry Directors, but that the detail of the rights, appointment process and terms of reference of Executive Directors should be developed during the Assessment Procedure.

The GSMG considered the rights, nomination and appointment process and terms of Office for Executive Directors under the Proposed Amendment. The GSMG's conclusions are summarised in Table A of the Modification Report.

### **Responses to Consultation**

A consultation document was issued by the GSMG on 10 March 2004, seeking responses by 19 March. Eleven responses (representing 52 Parties) were received. The consultation document was also issued to the Board, following a decision by a majority of the GSMG. The Board did not provide a formal response, as it did not consider it was appropriate to do so.

In relation to the consultation question of whether Proposed Modification P161 would better facilitate achievement of the Applicable BSC Objectives, 9 of the 11 responses disagreed with the question, one response agreed (the Proposer- representing one party) and one response (representing one party) made no comment on this question. The responses are summarised in the Assessment Report for Modification Proposal P161, which also includes the complete text of all respondents' replies.

The draft Modification Report was issued for consultation by the Panel on 14 April 2004, seeking responses by 28 April. Eight responses (representing 38 parties) were received. Responses were sought on three questions. The first question sought views as to whether respondents agreed with the Panel's views on P161 and the provisional recommendation to the Authority in the draft Modification Report that P161 should not be made. Six of the respondents (representing 36 parties) agreed with the question, one disagreed (the Proposer- representing one party) and one (representing one party) expressed no opinion.

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<sup>5</sup> The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of NGC's Transmission Licence, are:

- a) the efficient discharge by the licensee of the obligations imposed upon it by this licence;
- b) the efficient, economic and co-ordinated operation by the licensee of the licensee's transmission system;
- c) promoting 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;
- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements
- e) the undertaking of work by BSCCo (as defined in the BSC) which is:
  - (i) necessary for the timely and effective implementation of the proposed British Electricity Trading and Transmission Arrangements (BETTA); and
  - (ii) relevant to the proposed GB wide balancing and settlement code;and does not prevent BSCCo performing its other functions under the BSC in accordance with its objectives.

The respondents who supported the provisional recommendation that P161 not be made gave a variety of reasons for their response, which included the reason that Modification Proposal P161 did not better facilitate the achievement of the applicable BSC Objectives. The respondents' views are summarised in the Modification Report for Modification Proposal P161, which also includes the complete text of all respondents' replies.

### **Panel's recommendation**

The Panel met on 13 May 2004 and considered the Modification Proposal, the draft Modification Report, and the consultation responses received. The Panel recommended, by a majority, that the Authority should not approve the Proposed Modification, but that if it did approve the modification, the implementation date should be 30 days after the Authority's decision.

The majority of the Panel members agreed with the majority GSMG view that Modification Proposal P161 would not better facilitate achievement of the Applicable BSC Objectives, and were not persuaded that a case for change had been made. Specifically, the majority were not convinced that placing some BSCCo executives on the Board as Executive Directors would be more beneficial than simply requiring these executives to attend Board meetings.

Within this majority view, several Panel members supported the GSMG view that the original DTI/Ofgem rationale for the current non-Executive Board was that such a structure would provide assurance that BSCCo would be subject to independent and effective scrutiny and control. Two Panel members noted the view expressed by some members of the GSMG and consultation respondents that independent budgetary control of the BSCCo was essential due to the funding arrangements of BSCCo. One Panel member noted that the consultation responses (some of which were from organisations who did not usually respond to consultation) provided a clear message of opposition to the change.

A minority of Panel members disagreed with the majority GSMG view. These members believed that Modification proposal P161 would better facilitate achievement of the Applicable BSC Objectives. These members agreed with the Proposer's view that the Modification would better facilitate communication between the Board and management and effective scrutiny of BSCCo by the Board.

Panel members holding the minority view believed that the GSMG's concerns that the Proposed Modification would result in the Executive Directors having conflicting objectives were unwarranted. These members noted that mixed Boards are considered as 'best practice' and used by many organisations, and also noted that the legal duties of Directors to act in the best interests of the company would counter any such conflict.

Panel members holding the minority view further believed that the GSMG's concerns that the Proposed Modification would dilute the 'industry perspective' of the Board were unwarranted. These members noted that the Industry Directors would still be present on the Board. One of the Panel members stated that the balancing and settlement arrangements were for the benefit of consumers and so ensuring that the BSCCo was accountable to stakeholders other than industry would be best achieved by empowering the Board to scrutinise BSCCo as effectively as possible.

One of the Panel members holding the minority view also supported P161 because of the belief that it would improve internal succession planning for the role of Chief Executive.

### **Responses to Ofgem GB Consultation**

On 5 December 2003 Ofgem undertook to invite responses on additional implications that a Proposed Modification may have, were it to be applied on a GB wide basis, as opposed to being limited to England and Wales. In order to discharge this undertaking Ofgem published a GB Consultation Paper on 25 May 2004 which invited respondents' views by 5pm on 21 June 2004. One response was received. The response did not identify any such additional implications.

The Consultation Paper can be found on the *BETTA GB Consultation* section of the Ofgem website.<sup>6</sup>

### **Ofgem's view**

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that Proposed Modification P161 will not better facilitate achievement of the Applicable BSC Objectives.

The Proposer suggested that the Modification Proposal would facilitate achievement of Applicable BSC Objectives (c) and (d).

Applicable BSC Objective (c) is:

*"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."*

The Proposer stated that the Modification Proposal would facilitate the achievement of this objective by facilitating cost reductions and improvements in the efficiency of BSCCo, which would reduce costs to participants and therefore reduce barriers to entry and enhance competition in the generation and supply of electricity. The GSMG considered that the impact of the Modification Proposal on Applicable Objective (c) would be "very much a second order effect."<sup>7</sup> The majority of the Panel members agreed with this view. Ofgem supports these views.

Ofgem considers that if the Modification Proposal was implemented and reduced the costs of BSCCo, it is unlikely that such savings would have a significant impact on the barriers to entry for new participants. Ofgem therefore considers that the Proposed Modification is unlikely to promote competition and hence facilitate Objective (c).

The other Applicable BSC Objective cited by the Proposer in support of the Proposed Modification was Objective (d):

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<sup>6</sup> <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/bettagbcons>

<sup>7</sup> "Assessment report for Modification proposal P161 Enhancement of BSCCo Board Structure" 75/101. Prepared by GSMG and issued 2 April 2004, section 1.5

*“the promotion of efficiency in the implementation and administration of the balancing and settlement arrangements.”*

The majority of the GSMG and the majority of the Panel held the view that P161 would not better facilitate achievement of this Objective. This majority view held that no case for change had been made, and that the benefits of making some BSCCo executives Executive Directors- rather than requiring these executives to attend Board meetings had not been demonstrated. Ofgem agrees with this majority view. Ofgem considers that evidence has not been provided as to how the Proposed Modification would better facilitate the achievement of Objective (d).

Ofgem has considered the minority view of the Panel and GSMG, and has noted the view that mixed Boards (with both Executive and non-Executive members) are considered ‘best practice’. However, while the implementation of P161 would move the Board closer towards such ‘best practice’, Elexon’s role and structure is unlike that of most organisations and therefore Ofgem considers that it would not necessarily better facilitate efficiency in the implementation and administration of the balancing and settlement arrangements.

For the reasons stated above, Ofgem has therefore decided not to direct a modification to the BSC in line with Modification Proposal P161.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'A. N. Simpson', written over a horizontal line.

**Nick Simpson**

**Director, Modifications**

Signed on behalf of the Authority and authorised for that purpose by the Authority