ELEXON

Stage 04: Draft Mod Report

What stage is this document in the process?

01 Initial Written Assessment

02 Definition Procedure

03 Assessment Procedure

04 Report Phase

P289: Enabling ELEXON to participate in tendering for the DCC Licensee role via a subsidiary

P289 would amend the BSC to allow ELEXON to establish a subsidiary which can participate in the Data Communications Company (DCC) bid process and, if successful, act as DCC.

Initially, the Panel recommends
Approval of Modification P289

High Impact: BSCCo (ELEXON)
Of interest to all BSC Parties - no direct operational impact, but:

- Would change the scope of ELEXON's permitted activities;
- Implications for funding BSC services; and
- Implementation costs for Parties - capped, repayable to Parties, but at risk depending on outcome of DCC bid

Panel paper number

P289
Draft Final Mod Report

Day Month Year

Version 0.2

Contents

About this document:

This is the P289 Draft Modification Report, which ELEXON is issuing for industry consultation on the BSC Panel's behalf. It contains the Panel's provisional recommendations on P289. The Panel will consider all consultation responses at its meeting on 15 January 2013, when it will agree a final recommendation to Ofgem on whether or not the change should be made.

There are two parts to this document:

- This is the main document. It provides details of the solution, impacts, costs, benefits/drawbacks and proposed implementation approach. It also includes the initial recommendations which the Panel has made after considering the Assessment Report.
- Attachment A contains the draft redlined changes to the BSC for P289.

For further information, please see the P289 page of the ELEXON website.

Any questions?

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1 Summary

Why Change?

ELEXON cannot participate in the bidding process for the award of DCC License under the current BSC drafting which contains constraints that preclude ELEXON or its subsidiaries undertaking work outside the BSC.

Modification Proposal P289 contends that ELEXON participating in the DCC bidding process and, if successful, performing the DCC Licensee role, would have benefits for Parties under the BSC and for the wider industry.

Proposed Solution

Amend the BSC such that ELEXON is permitted to undertake activities outside of the BSC, specifically, the DCC Licence Application process. This will be achieved by establishing a subsidiary company, wholly by BSCCo, which can participate in the DCC Licence Application process and, if successful, undertake the DCC role. As the sole shareholder of DCCCo 100% of declared dividends from DCC activities would be paid to BSCCo and used to offset BSC costs.

The Workgroup did not develop an Alternative Modification. Some Group members felt that was due to lack of time.

Impacts & Costs

Includes provisions for Parties to fund an ELEXON bid for the DCC Licensee role which would be capped at £600,000 (up to £300,000 for internal resources and £300,000 for external costs), such funding would be reimbursed in the event of a successful bid.

Implementation

1 working day after an Authority decision is received.

The Case for Change

The majority of the Panel believed that P289 better facilitated applicable objective (d) as they believed that there would be potential benefit of ELEXON becoming the DCC Licensee, in the form of efficiency savings and offsetting BSC costs with potential DCC dividends (thereby potentially reducing Parties' BSC costs), and this potential benefit outweighs the definite (but capped and potentially repayable) cost of a DCC bid.

The minority of the Panel believed that the potential risk to BSC services and the mandatory funding outweigh any potential benefits.

Recommendations

The Panel's initial majority recommendation is that the P289 Proposed Modification should be approved.

The majority of the Panel believed P289 would have benefit against Applicable BSC Objective (d).

2 Why Change?

Background

ELEXON administers the Balancing and Settlement Code (BSC) by fulfilling the role of BSC administrator on a not for profit basis. Although ELEXON is a wholly owned subsidiary of NGET, NGET does not have a place on ELEXON's Board and has no financial or other obligations or management control over ELEXON. ELEXON's costs are borne by industry and it has successfully reduced its overall running costs year on year1. A restriction in the BSC prevents ELEXON from providing services to government or industry beyond the BSC.

In 2010 ELEXON first communicated its belief that its expertise and experience should be applied more widely for the benefit of industry, government and, ultimately, the consumer as part of its 2011/12 Business Plan.

As a result of responses received to the Business Strategy consultation in February 2011, and an Industry workshop in March, Issue 40 'Review of ELEXON Governance and Funding Arrangements for New Business Opportunities' was raised by E.ON in March 2011. Issue 40 considered options for an appropriate governance framework to allow BSCCo to pursue business development opportunities which it was precluded from under the Code. The Issue 40 group was tasked with considering and developing a number of viable governance proposals which could form the basis for one or more future Modifications.

The Issue 40 group also considered:

- The extent to which ELEXON should be permitted to pursue new business development opportunities;
- The process for setting budgets, authorising expenditure and ensuring effective accountability to BSC Parties;
- Funding arrangements and the extent to which costs and risks should be allocated to BSC Parties that benefit from new business developments;
- How surplus income generated from new business development opportunities are used including (a) consideration of repayments to parties required to/choosing to fund such activities and/or (b) reductions to BSCCo Charges;
- The separate accounting and ring fencing of new business activities from existing BSC activities, and whether new organisation or ownership structures are required;
- The respective roles of the Board and BSC Panel, the Transmission Company and Trading Parties (for the above); and
- An appropriate regulatory regime.

The Issue 40 Group discussed three potential models, which in summary are:

- **Model A** - the creation of a new umbrella holding company to be the parent of an ELEXON Group. BSCCo would become a wholly owned subsidiary of this new holding company (rather than National Grid), but is otherwise unchanged in structure, funding, role or governance and remains cost pass through/non-profit making. New business ventures would be competed for and delivered as ring-fenced subsidiaries of the new holding company;

[1] In real terms, ELEXON's running costs have fallen year on year from £106.5 million in 2001/02 to £33.9 million (latest forecasted budget) for 2012/13.

- **Model B** - the creation of a new company to procure and manage a BSC services company which would provide all the services that BSCCo does today, but under a contestable commercial services contract. The ownership, governance, funding and profit status of ELEXON Limited would be changed. The BSC ServeCo contract would include a profit margin and appropriate incentives to reduce charges; and

- **Model C** - the existing governance and funding of BSCCo as a wholly owned subsidiary of National Grid remains. All future roles would be undertaken by ELEXON under this structure via incremental modification of the BSC.

The Issue 40 Group concluded that Option C should not be progressed. However, options A and B could potentially be used to enable ELEXON to undertake a wider set of business activities. The Group preferred Model B.

Parallel and separate to Issue 40, Ofgem commissioned an independent advisor (Richard Morse) to deliver a report on any issues that might arise from ELEXON diversification and how such issues could be addressed. The Morse Report was published on 29 July 2011, six weeks before the Issue 40 report was published (in September 2011).

Following the Morse Report, Ofgem issued a consultation in November 2011 on the potential expansion of ELEXON's scope and vires to allow it to take on additional work beyond that set out in the BSC. Ofgem acknowledged that the main driver for ELEXON's diversification was the role of the DCC and considered that "there may be some synergies between the processes currently run by ELEXON and the anticipated role of the DCC, as well as the potential for cost savings from the more efficient use of its fixed assets and other resources. Consumers may therefore benefit from ELEXON"s participation in the competition to undertake the DCC role."

The November consultation set out four expansion conditions that would need to be satisfied before any expansion could occur, with the aim of protecting BSC Parties and ultimately consumers. These expansion criteria were:

- Criteria 1 - BSC Parties should not face higher costs

- Criteria 2 - The arrangements should not place more risk on BSC parties

- Criteria 3 - Standard of service should be maintained

- Criteria 4 - ELEXON's s BSC role should not give it any undue advantage in the DCC competition

The consultation also identified two possible restructuring models (the "contract model" and the "subsidiary model") that could satisfy the expansion conditions. Ofgem's preliminary view was that while either of the two models would be viable, "the contract model has certain advantages that might make the fulfilment of those conditions more certain, and potentially the simpler of the two to implement.

On 30 April 2012 Ofgem concluded that ELEXON should be allowed to do more if the expansion criteria are satisfied, and reaffirmed their view that a contract model appeared most likely to effectively mitigate the size and nature of risks associated with ELEXON undertaking an activity such as the DCC.

As part of this April conclusion document Ofgem also amended he expansion criteria to:

- BSC Parties should benefit from any diversification;

- The arrangements should not place disproportionate risk on BSC Parties;

- Standards of service under the BSC should be maintained; and
- ELEXON's BSC role should not give it any undue competitive advantage in a contestable activity.

As part of their conclusions Ofgem also acknowledged the concerns raised by several consultation respondents that a contract model may be more expensive to implement and therefore suggested that there may be more proportionate means of allowing a limited expansion of ELEXON's activities without requiring its separation from the BSCCo in the form of the BSC Board.

As a result of the Ofgem conclusions letter National Grid raised Modification P284 (Expansion of ELEXON's role via the 'contract model') in May 2012. P284 sought to amend the BSC to enable the BSCCo Board to outsource its activities to a new entity ('New ELEXON') under a for-profit contract, if it chose to do so. P284 was rejected by the BSC Panel, but was approved by Ofgem in September 2012.

On 27 November 2012, ELEXON's Board concluded that, whilst ELEXON diversification may undoubtedly bring longer term benefits to consumers, the industry, Government and to staff, the proposed contract model could not meet one of Ofgem's four expansion conditions and therefore the contract model could not be pursued at this time.

The condition that the Board could not resolve was 'BSC Parties should benefit from diversification'. This proved impossible when considering a shift from a not for profit to a for profit service which, would be coupled with increased overheads arising from the need for two companies (customer and provider) where there had been only one in the past. The Board considered that the benefits of profit share and overhead reduction arising from new work could not by their nature be quantified or guaranteed at this time, and therefore did not believe that, at this time, such benefits could be considered to outweigh the costs that would definitely arise from the change to the service.

The Board, recognising that there may be benefits of diversification and the specific opportunity of the DCC Licence Award, requested that ELEXON explore how to enable participation in the Licence Award. At the subsequent meeting of the Board on 5 December the Board was informed that a Modification concerning Smart activities was being developed. A paper was circulated to the Board asking that they:

- Recommend to the BSC Panel that a BSC Modification is raised, on the grounds of efficiency, to enable ELEXON to bid for the DCC/SEC; and
- Recommend to the BSC Panel that in light of the pressing timescales, the Modification is progressed as an Urgent Modification.

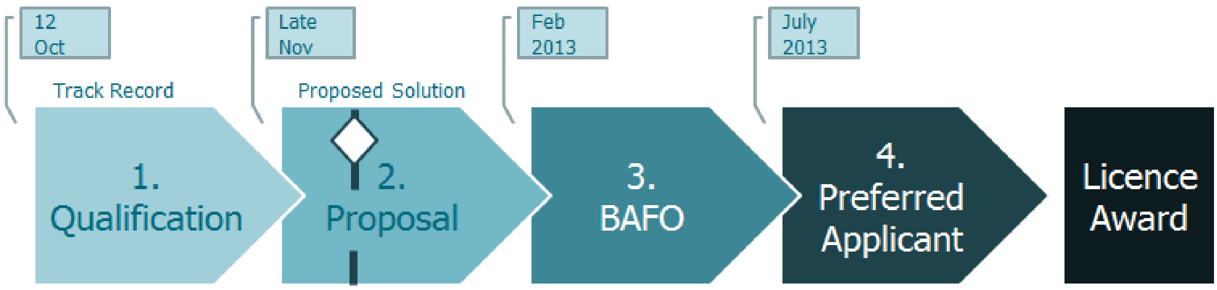
On the grounds that a Modification was limited solely to the DCC and SEC roles, and did not compromise delivery of the BSC services, of the five non-executive directors the recommendations were supported by four (including the Chairman), and hence the request from the BSCCo Board that the BSC Panel raise a Modification and treat it as an Urgent Modification. A copy of the Board paper and statements from each of the Board members was tabled at the Panel meeting on 13 December 2012.

The Data and Communications Company (DCC)

As part of the new smart metering arrangements a new licenced body, the DCC, will be established to manage the delivery of the central arrangements.

The DCC is a key element of the Government's approach to rolling out smart meters in Great Britain. The principal role of the DCC will be to procure, manage and assure communication services with smart meters at all domestic gas and electricity consumer premises. Recognising the strong parallels with services that ELEXON currently provides under the BSC, the opportunity is strongly aligned to ELEXON's vision.

The DCC will be appointed through a competitive Licence Application process which has already started. ELEXON (via a separate non BSCCo entity) has qualified from the first stage of the four stage Licence Award Process and is well placed to continue. In order to progress its application ELEXON needs to be able to deploy its resources (principally undertaking work at risk) and have a clear corporate structure for its submission. A means of addressing this is put forward in this Modification. Recognising that the award process is active places time pressure on resolving this issue and hence the expedited timetable. The key steps in the Licence Award process and their timings are illustrated below:



The DCC role has been under discussion for several years. With the emergence of the DCC Licence and the Version 1 of the Smart Energy Code there is now clarity around the role and the attendant risks and rewards. ELEXON have progressed a delivery model and has successfully demonstrated its track record of delivery in qualifying in the first stage of the award process.

In recommending this Modification the majority of the Board sought confirmation that the risks around the DCC have been clarified and significantly contained since the role was initially proposed. For example, it is not responsible for the defaults of its service providers, and liabilities (that it does have to assume) are commensurate with the risks and rewards; furthermore it can be socialised amongst its users.

The Board also sought confirmation that the DCC will receive revenue from Licence award and so is not required to fund months of mobilisation prior to invoicing its users (invoicing a month in arrears there would be a short period (circa 1 month) from the Licence Award date, that the DCC would need to cover its own operating costs prior to the first invoicing. If required these working capital requirements would be covered by a bank loan to the DCC, the costs of which would be factored into the bid price). BSC Parties would not be required to fund the DCC's working capital requirements.

The Board also discussed how a failure of the DCC infrastructure would adversely impact settlement through disrupting the flow of metered data and possible misallocation of energy resulting in severely compromised data quality. Conscious of the disruption that occur in supply competition in 1994, the Board recognised that ELEXON through its BSCCo role has an overwhelming imperative to ensure that the DCC arrangements function efficiently and effectively. The Board also recognised that ELEXON have a natural incentive to drive the roll-out since ELEXON and hence BSC Parties will bear the inefficiency of operating duplicated legacy and smart arrangements. If this were to occur it could also constrain the smarter markets initiative and the development of smart grids.

ELEXON and the majority of the Board believe that participation in the DCC bid may be beneficial to the industry and ultimately the consumer. As a participant with a clear proposition, ELEXON's continued participation in the Licence process enhances the competitive process, introduces downward pressure on costs which will contribute to developing the best solution which will benefit Government, parties to the Smart Energy Code (SEC), and ultimately the consumer. Quantify that statement or remove it. These benefits will arise irrespective of who is awarded the DCC Licence. If successful, shared assets, overheads, processes and services may lower the costs of the BSC arrangements. ELEXON recognises that participating means committing BSC resources (and hence costs) but believe this may be outweighed by the benefits that enhanced competition will bring.

The Identified Issue

ELEXON cannot participate in the DCC Award process due to the current BSC restrictions.

The key constraints currently imposed on ELEXON Ltd by the BSC include provisions which preclude ELEXON or its subsidiaries undertaking work outside the BSC, and which therefore prevent:

- ELEXON or its subsidiaries from providing DCC services outside its core BSC activities; and
- ELEXON or its subsidiaries holding interests in appropriate legal entities to deliver DCC services outside the BSC.

Raising P289

The Panel considered the request to raise a Modification from the BSC Board at its meeting on 13 December 2012 (Panel 206/17 - paper and attachments available from the Panel 206 page of ELEXON's website). Following its discussions, the Panel agreed by majority to raise Modification P289. The Panel made some amendments from the draft Modification Proposal attached to the paper, primarily to remove from its scope the SEC Administrator role. The Panel's considerations in relation to the request to raise a Modification, its discussions and its agreed decisions will be documented in the minutes for Panel 206, which will be available on the Panel 206 page of ELEXON's website.

3 Solution

Overview

The proposed solution is to allow a limited expansion of ELEXON to undertake only the DCC bid and DCC role if it were successful in the bid. This would be done via a separate subsidiary (called 'DCCCo' in this Modification) of which BSCCo would be the sole shareholder.

The solution is designed to ring fence BSCCo from any costs and risk associated with running the DCC. BSC Parties would provide funding for the DCC bid, but that funding has been capped at £300,000 for external costs and £300,000 for internal resources. Because the funds would be drawn from the underspend in the 2012/2013 Annual Budget, Parties would not be asked to make any additional payments, and if successful the funds would be recouped from the operation of the DCC and repaid to Parties.

The Modification requires that declared dividends remitted by DCCCo to BSCCo would be used to defray BSC Parties costs.. Additionally, DCCCo would be required to meet a proportion of BSCCo's fixed overheads (occupation costs for example) and this would further defray BSC Party costs.

Key Features of Proposed Solution

Establishing a 'DCCCo' subsidiary

- ELEXON will be able to pursue opportunities only for the award of the DCC Licensee via a group company. We refer to 'DCCCo' throughout this Modification when referring to such company;
- DCCCo will be:
  - Wholly owned by BSCCo for the benefit of BSC Parties; and
  - A separate legal entity thus all costs and liabilities incurred by DCCCo will be kept separate from BSCCo's core BSC services;
- If DCCCo is awarded the DCC Licensee role, 100% of dividends declared by DCCCo will be distributed to BSCCo (for the benefit of BSC Parties in accordance with their funding shares, thereby representing a cost saving to BSC Parties). The declaration of dividends by DCCCo will be subject to the approval of the BSCCo Board;
- BSCCo will have no financial liability or obligation to DCCCo, subject to the provision of DCC Tender Costs (see below);
- BSCCo may not place DCCCo in breach of its legal requirements (e.g. DCC licence obligations);
- The Board of BSCCo will appoint the initial chairman of DCCCo. The initial chairman of DCCCo will in consultation with the Panel appoint other initial directors. DCCCo will comply in all material respects with the UK Corporate Governance Code (subject always to the preceding point that BSCCo may not place DCCCo in breach of its legal requirements); and
- ELEXON is prohibited from disposing of DCCCo (existing Section C, paragraph 3.4.5(c)).

Funding of DCC Licensee bid

- Subject to the following conditions, BSCCo may provide funding for the award of the DCC Licensee role in the form of a loan/credit to DCCCo in order to enable it to meet its costs, expenses and other outgoings in connection with the planning, preparation and negotiation of a Licence/contract ("DCC Tender Costs"). These conditions are:

  (i) Third party costs incurred in connection with the DCC Tender exercise (e.g. professional advisor costs) will be limited to £300,000[2];

  (ii) DCCCo's overheads (e.g. personnel costs) incurred in connection with the DCC Tender exercise will be initially met by BSCCo and limited to £300,000;

  (iii) DCC Tender Costs must be at arm's length and on normal commercial terms[3];

  (iv) DCC Tender Costs will be subject to ELEXON's statutory audit;

  (v) If DCCCo is awarded the DCC Licensee role, it will repay aggregate DCC Tender Costs to ELEXON within a period no longer than five years, and sooner if possible. For the purposes of repayment, Aggregate DCC Tender Costs will comprise:

    (a) DCCCo's third party costs plus interest at the agreed rate; and

    (b) DCCCo's overhead costs repayable on a capital repayment basis.

    BSC Parties will, in turn, be reimbursed in accordance with their respective Funding Shares;

  (vi) If DCCCo is unsuccessful in tendering for the DCC Licensee role ELEXON will write off the DCC Tender Costs in respect of that unsuccessful bid (on the basis that DCCCo will have no assets);

  (vii) All unused funding will be returned by DCCCo to ELEXON; and

  (viii) ELEXON will be under an explicit BSC obligation to procure that DCCCo provides reports to ELEXON Board at regular intervals on DCC Tender Costs (excluding confidential and/or commercially sensitive information).

Prohibition of cross-subsidies

- ELEXON will be under an explicit BSC obligation not to give or receive any cross-subsidy from any affiliate[4];
- If DCCCo is awarded the DCC Licensee role ELEXON will be under an explicit BSC obligation to develop procedures to ensure that any common or shared costs are allocated fairly and reasonably between ELEXON and DCCCo (i.e. DCCCo will not pay less than market rate); and
- Intra group company transactions will be subject to ELEXON's statutory audit.

Continuity of BSC services

To ensure there is no degradation in ELEXON's BSC services, ELEXON will be under an explicit BSC obligation to ensure that at all times it has sufficient dedicated resources (including personnel) to fully discharge its BSC responsibilities.

[2] There is sufficient underspend in the 2012/2013 Annual Budget to cover the DCC Tender Costs.
[3] This provision reflects, in part, Standard Condition B9 of NGET's transmission licence.
[4] This provision reflects Standard Condition B5 of NGET's transmission licence.

4 Impacts & Costs

Costs

The estimated implementation costs range from £50,000 to £600,000 depending on how far ELEXON proceed in the DCC bid. For full details of implementation costs and how these would be incurred see section 7 of this document.

Impacts

Impact on BSC Parties and Party Agents
As a change to the BSC governance arrangements, P289 will be of interest to all BSC Parties and stakeholders. BSC Parties will also be required to fund the BSCCo bid in relation to their funding share. If successful these funds will be repaid to BSCCo Parties.

Impact on Transmission Company
ELEXON believes P289 has no impact on National Grid in its roles as the Transmission Company or BSCCo Shareholder. However, the Transmission Company considers that P289 is likely to impact its licence. Further detail can be found in section 10.

Impact on ELEXON
ELEXON will have the ability to participate in the DCC bid process via DCCCo and, if successful, would be able to deliver the DCC role.

Impact on Code	
Code section	Potential impact
Section C, 'BSCCo and its Subsidiaries'	Amend to enable BSCCo to establish a subsidiary for the purpose of the DCC licensee role and implement the provisions of the P289 solution.
Annex X-1, 'General Glossary'	Introduce new terms relating to the new provisions in Section C.

5 Implementation

Implementation Approach

The P289 Workgroup recommends an implementation approach of:

- 1 working day following an Authority decision.

Given the short timescales involved, the Workgroup considered whether it would be useful to recommend an implementation approach that would allow implementation on the same day a decision is received. However, the Workgroup noted that once a decision is received it remains necessary to obtain the formal direction to modify the Code from National Grid, and depending on the time of day at which a decision is received it may be simply unfeasible for the Modification to be implemented on that day.

The Workgroup discussed whether it would be useful to develop an implementation approach using the DCC bid deadline in January to construct a decision cut-off date, but considered that the Authority would be aware of the significance of the DCC bid timetable and would be mindful of the interaction with its decision, and agreed that it was preferable to keep the implementation approach as flexible as possible.

The DCC Bid Process

The Workgroup received an update from ELEXON on the DCC process so far, including that DECC had moved the deadline for submission of any DCC bids from Monday 14 January 2013 to Monday 21 January 2013. There had been no formal announcement, but it was ELEXON's understanding that three other tenderers had progressed to the same stage as the bid with which ELEXON is currently associated (subject to change to permit ELEXON to continue that association into the formal bid stage of the process) and would be submitting bids for the DCC Licensee role.

The Workgroup noted that ELEXON reported that the organisation that acts as the DCC Licensee must be independent of the industry participants that it services. A Workgroup member queried whether BSCCo's status as a shareholder of DCCCo would cause any issue with regard to this requirement, and ELEXON explained that there was no problem in this respect because BSCCo has no direct relation with industry participants. The Workgroup further noted that though National Grid is the sole shareholder of ELEXON (as BSCCo) it does not control ELEXON and has no financial or other obligation (in particular arising from a failure of BSC systems and processes).

The ownership relationship between NGET and BSCCo is established under Section C2.2 of the BSC. The ownership relationship is most unusual in that National Grid:

- does not have a place on the Board of BSCCo
- exercises no control over BSCCo
- has no financial obligations to BSCCo or to BSC Parties
- does not consolidate the accounts of BSCCo into its own
- receives no dividend or other disbursements from BSCCo.

Furthermore, NGET may be directed by the Authority to transfer its shares to such person as the Authority considers appropriate.

The ownership relationship between BSCCo is more straightforward and traditional relationship that exists. BSCCo is the sole shareholder of DCCCo which is the sole beneficiary. The draft legal text (see C10.4.1) makes it clear that BSCCo shall at all times be the registered holder of all of the shares in DCCCo. ELEXON believes that the draft legal text includes the appropriate safeguards and protections for BSC Parties.

Initial DCC Funding

The Workgroup considered how the DCC Licensee would recover costs prior to the go-live of the DCC arrangements. DCC go-live will be over an extended period of time (anticipated to be around 18 months), with the costs identified by the successful bidder being funded by SEC Parties (mainly gas and electricity Suppliers) under license obligations based on market share.

A Workgroup member felt that there were outstanding issues around the initial funding of DCC activities, e.g. how exactly participants' market share would be determined for the purposes of the DCC and how funds would be collected, but were satisfied that these issues would be the same for whichever organisation is the DCC Licensee and funding would be covered by the DCC arrangements (i.e. the necessary information and powers to collect funding would be part of the DCC arrangements) and set out in the SEC.

ELEXON explained that the DCC Licensee can begin to collect funds from parties 1 month from award of the Licence, around August 2013, and would not have to pay any service providers until 2014. However, there would need to be some funding during this initial 1 month period, when the DCC Licensee is procuring resource but funds have not yet been obtained. Such funds would not be drawn from the DCC bid loan monies, which are specifically for the DCC bid only. ELEXON/DCCCo would obtain the funds for initiating the DCC service via a bank loan secured against the 12 year DCC License award though this would be a strictly short term bridging loan; the DCCCo would not take on any structural debt to operate.

ELEXON confirmed to the Workgroup that zero capital would be required up front from the successful DCC applicant due to the above arrangements.

The ELEXON bid

A Work Group member questioned how the ELEXON partnership had put in a bid and wanted to clarify how this body could become DCCCo.

ELEXON explained that the company that has responded to the DCC PQQ process is a new company called "The ELEXON Partnership Ltd" (TEPL) which was incorporated on 26 September 2012. It was created solely to submit a PQQ response and to progress a DCC tender submission. Due to the existing BSC restrictions, it is not and could not be, a subsidiary of BSCCo until the BSC is modified. There are four issued shares of TEPL, each with a nominal value of £100. Immediately upon, and only if, P289 is approved and implemented, those 4 shares, being all of the shares in TEPL, will be transferred to BSCCo so that BSCCo becomes the holder of all of the shares of TEPL. TEPL will be the DCCCo. The shares will be transferred for their nominal value (i.e. 4x£100) and for the avoidance of doubt, no gain will be made by the existing shareholders. This has been agreed with the existing shareholders of TEPL. The transfer of shares is a simple process requiring the execution of stock transfer forms and the registration of the new holder of the shares (BSCCO) in the register of members of DCCCo, which can be effected on the same day as P289 is implemented.

Interaction with EMR

A Workgroup member queried whether there was any concern around ELEXON's ability to potentially deliver relevant aspects of the Electricity Market Reform (EMR) work if it were to become (via a subsidiary) the DCC Licensee. The member was concerned that the DCC role could cause resource issues that would affect EMR, and believed that ELEXON's ability to carry out EMR work would be a greater concern to industry participants than whether or not ELEXON is able to bid for and perform the DCC role (i.e. a DCC bid by ELEXON should absolutely not jeopardise ELEXON capability in relation to EMR). Specifically, the Workgroup member believed that a capacity mechanism relating to EMR would certainly go through the BSC, and was therefore concerned that valuable ELEXON expertise that could contribute to the development of the capacity mechanism should not be distracted by DCC (or any other non-BSC business).

ELEXON believed that performance of the DCC role would not cause it any resource issues, either in relation to BSC services and obligations, its general operation or specifically with regard to any role in EMR. P289 would introduce a Code requirement that BSC services are not impacted by the DCC bid or performance of the DCC role, and in any case it is in ELEXON's interests to maintain standards and to continue to deliver the BSC arrangements effectively.

It was questioned by a Group member what planning for EMR had taken place. ELEXON responded that it maintains dialogue with DECC and National Grid regarding EMR. Details of the settlement agent role have yet to be made available and are expected in secondary legislation. At this stage it is difficult to provide a plan for industry scrutiny, and no certainty that ELEXON will be the provider of settlement services (although ELEXON is encouraged by the references in the draft energy bill).

P289 Solution

The Workgroup stepped through the proposed solution and discussed each of the elements (highlighted in section 3 above) in turn. The following sections detail the questions and comments the Workgroup had under each of these headings. It should be noted that the Panel asked similar questions, so readers are advised to read section 3 and section 10 together as it provides a full picture of the solution.

Establishing a 'DCCCo' subsidiary

DCC Dividends

The Workgroup noted that any dividends paid by DCCCo to BSCCo would be passed on to all BSC Parties. But they questioned how would dividends be declared and what would happen if the BSCCo Board and DCCCo Board disagreed.

The Workgroup noted that a dividend policy would be agreed between the two boards and would form part of the shareholder arrangements, which is a contract between the Boards. It was noted that though DCCCo would submit its dividend policy (taking into account factors such funds it needs to retain for investment, etc) such policy would be subject to the ratification of the BSCCo Board; in short, DCCCo will not be able to withhold funds against the wishes of BSCCo.

The Workgroup noted that it should be made clear in the solution that such a policy would exist.

Further information on the dividend policy can be found in the panel discussion in Section 10.

National Grid and the Transmission Licence

The Workgroup discussed whether P289 would have any impact on the Transmission Licence, noting that a change was required to the licence when ELEXON took on the Warm Home work.

ELEXON's legal advice was that there was no impact on the Transmission Licence, this legal advice was not presented to the Group as it had not been formaly issued. Warm Homes was an activity that was added into the scope off the BSC, and therefore a change was required to the Transmission Licence to reflect the increased scope of BSC activities.

The Workgroup noted that the Transmission Licence describes the purpose and scope of the BSC, not BSCCo. The group asked Grid if they had sought legal advice externally, they had not.

A Workgroup member queried whether they was any risk that new paragraph C10.4.5, which obligates BSCCo not to cause DCCCo to breach its DCC requirements, would cause DCC obligations to take precedence or be prioritised over BSC obligations. ELEXON clarified that BSCCo and DCCCo would be separate legal entities with separate obligations, and this paragraph was solely to preclude BSCCo in its position as DCCCo shareholder from placing any requirements on DCCCo to the detriment of the delivery of the DCC obligations.

Funding of DCC Licensee bid

Implementation Costs, Risk and Repayment

The Workgroup noted that P289 would introduce a particular term, 'DCC Tender Costs', relating to costs associated with a DCC Licensee bid, and would specify that such costs may not exceed:

- £300,000 for external costs (such as professional advice and other requisite outgoings); and
- £300,000 for internal overhead costs (including personnel) incurred either by BSCCo on behalf of DCCCo or by DCCCo itself.

It should be noted that these are the maximum costs that may be accrued and DCC bid costs would not necessarily reach these amounts (and indeed are unlikely to, even in the case of a successful bid). External spend is subject to ELEXON's established controls and processes to authorise and monitor all expenditure. Furthermore, the amount spent on a bid will depend upon the stage ELEXON reaches in the bid process, while the concomitant risk varies accordingly. ELEXON believes that its initial efforts to enable a bid to be submitted are likely to have an associated cost of around £50,000 at most, and this is the stage at which a bid is most likely to fail. After this stage of the bid competitors would expect to be part of a narrowed field (the preferred bidder select others) and the work associated with the bid, and therefore the cost, would increase, but with more chance of success.

The Workgroup noted that the draft legal text accompanying the P289 Modification Proposal provided for the DCC Tender Costs to be repaid to BSCCo (at which point they will be repaid to Parties) within 12 years (since the term of the DCC Licence award is 12 years). The Workgroup considered that besides the risk that an ELEXON bid could be unsuccessful (in which case such funds could not be repaid), this arrangement penalises any participants that are currently Parties but which are not Parties when the funds are repaid (and conversely new Parties will benefit from the repayment of funds to which they did not contribute).

The Workgroup considered that it is in the interests of BSCCo and DCCCo to repay funds as soon as possible to minimise the required interest payment. Some of the Workgroup were comfortable with the 12 year repayment term as they had no particular objections and considered that the amount of funds was not significant in the context the funding of the BSC. However, the Workgroup believed the 12 year term is unnecessarily long and that a shorter period would be more appropriate and would mitigate to some extent the risk associated with Parties leaving and joining the BSC arrangements. The Workgroup therefore agreed that the repayment term should be reduced to no more than five years, and earlier if possible. A group member noted that this may limit the intergenerational issue, but would not resolve it.

Providing Security

The DCC bid process requires a financial security for the operation of the DCC. The Workgroup noted that, whilst it was not ELEXON's intention to get security from BSC Parties and that the P289 provisions would restrict ELEXON from providing security to its DCC subsidiary, the original solution drafting still provided for security to be provided if the BSC Panel agreed.

The Workgroup could see no reason for this and believed it would be clearer and would provide greater certainty of Parties financing obligations if this ability was removed. The Workgroup believed that DCCCo should have no issue of gaining a bank Letter of Credit if it was in the bidding process as described above.

The Workgroup therefore agreed that the P289 solution and legal drafting should be amended to completely preclude any cost or risk being placed on BSCCo or BSC Parties in order to provide funds or security to DCCCo (other than in respect of the bid costs).

Prohibition of cross-subsidies

A Workgroup member queried how the sharing of fixed overheads between ELEXON and its DCC subsidiary (thereby delivering efficiency benefits) was reconciled with maintaining 'arms length' commercial arrangements between the two. The Workgroup were concerned that P289 did not contain sufficient safeguards to ensure BSC services are maintained and preclude negative impact from the DCC activities or to ensure effective separation of ELEXON resources and personnel.

ELEXON noted that it would be the BSCCo Board that would make the policy to ensure that resource was divided adequately and that BSC work took priority. It was noted that industry should gain some comfort from the new Board structure that was being introduced under P281. The debate under issue 40 was also noted where the Issue 40 Group concluded that "any use of BSC assets and resources for non-BSC activities would be charged at arms-length rates at the discretion of and upon terms to be agreed by the BSCCo Board. Provision would need to be made for this in the BSC Business Plan and Budget (which are consulted upon) and set out in the financial accounts presented in the BSC Annual Report. Appropriate protections would be provided in any such contracts established by BSCCo for the provision of such BSC assets and resources to other companies".

The Workgroup discussed the use of more substantial and specific requirements in this area, for instance provisions around monitoring and enforcing BSC service levels. The Workgroup noted that under this model there is no form of financial or other recourse in the event BSC service levels are adversely impacted, except for removing the Chairman and the Board directors for not performing their roles.

The Workgroup did acknowledge that it was not practical to put detailed provisions in the Code that would steer BSCCo Board policy. However, they did believe that there should be reference that such a policy exists in the legal text and that it should give preference to BSC activities. The Work Group, noted that the Panel have a number of different reporting mechanisms and KPIs on BSCCo's performance. They urged the Panel to continue their monitoring of BSCCo and to highlight if they felt BSCCo's performance was slipping. Parties would then have the opportunity to challenge the BSCCo Board at their annual meeting (as per P281 solution) if they felt that BSC matters were not taking priority.

Overall Development of Solution and Changes to Legal Text

Based on its discussions the Workgroup agreed that a number of amendments should be made to develop the P289 Proposed solution, with the draft legal text updated accordingly to reflect these changes. The agreed changes from the draft legal text submitted with the P289 Modification, and the Workgroups reasons for these changes are documented throughout this section, and in summary are:

1) Replacement of references to 'DCCCo' with 'DCCCo' to reflect that the scope of the solution is now limited completely to the DCC Licensee role;
2) Removal of the ability of BSCCo to grant security, etc. to DCCCo - the term 'borrowing' incorporates security (see 10.4.4);
3) Insertion of an obligation on BSCCo to procure DCCCo's contractual agreement to a dividend policy and shared costs allocation (see10.4.6(e)) - this latter point is the mechanism by which BSC Costs would be defrayed; and
4) Reduction in loan payment term to a maximum of five years (see definition of 'DCC Tender Recovery Period').

The attached draft legal text reflects the Workgroup's agreed changes.

A Work Group member questioned whether the name DCCCo could be used into this Modification as it may already be used by another corporate entity. ELEXON explained that the use of DCCCo was simply a definition term in the BSC.

Potential P289 Alternative Modifications

As documented in this section, as part of its consideration and assessment of the P289 Proposed solution the Workgroup made several amendments to the solution and legal text to improve the solution while staying within the scope of the P289 issue. The Workgroup did not identify any Alternative solutions that it believed would better facilitate the Applicable BSC Objectives compared with the Proposed Modification while addressing the BSC defect identified by P289.

During the Work Group meeting the P289 Group did not identify any potential alterative solutions. This was partly because the Group had developed the modification whilst discussing the solution during assessment, but also reflected the very short time group members had to consider the modification prior to the meeting. Therefore, in the absence of any radically different approaches to the P289 issue, the process of developing an Alternative was not required.

Subsequent to the Work Group 2 members suggested potential alternative approaches. One of these had been discussed in the Group meeting. The other however, aware of the time constraints of P289 timetable, and noting that the Group had discharged its terms of reference the member raising one alternative asked for his idea to be raised at the Panel meeting to seek their opinions. Elexon did not manage to speak to the other member in detail prior to the Panel meeting.

For further information please see Section 10.

Comparison with contract model

The Workgroup noted that P289 had been raised following the BSCCo Board's decision not to use the provisions introduced by Modification P284 to outsource BSC Services via a contract, and considered how P289 differed from P284 in practice. The Workgroup noted that a contracted entity created under the P284 provisions would have been free to pursue any commercial opportunities it wished (its commitment in relation to the BSC being to deliver the BSC Services set out in its agreed contract) whereas P289 would create a particular subsidiary that would be restricted to the specific functions of bidding for and performing the DCC Licensee role.

It was noted that under a contract model one of the key issues was that it would in effect duplicate functions and means Parties would have to pay for that duplication. It would also mean parties have less control over the activities of the service provider than BSCCo currently, as they would be a one step removed by a contract.

The Workgroup discussed the relative merits of both models and ultimately came to the conclusions that the contract model provided BSC Parties with more control as if BSC services were not met financial penalties could be introduced. It was noted that under a subsidiary model the Chairman and Board directors could be replaced, but members felt that financial penalties of Service Level Agreements would be a better incentive to deliver. Some Group members did not believe that a contract model should cost more than the current or subsidiary model.

A view was noted to the Workgroup that the risk of a degradation to existing service levels, as a result of the implementation of P289, is no greater than today and significantly less than under a contract model, where the service provider would increasingly focus on achieving an appropriate profit margin and this could be at the expense of service levels.

As P289 does not impact underlying BSC service standards (albeit new obligations are proposed that reinforce BSCCo's obligations to have resources in place at all times to meets its BSC obligations) and that existing Board and Panel performance reporting continue, that any sustained underperformance of the BSC service would be quickly detected and the appropriate remedial actions taken.

7 Costs, Benefits and Funding

Once the Workgroup had walked through the P289 solution they were asked four specific questions from its Terms of Reference. This section sets out the questions and the Workgroup's answers.

Q1. Do you understand the monies at risk?

The Workgroup agreed that the monies at risk were as follows:

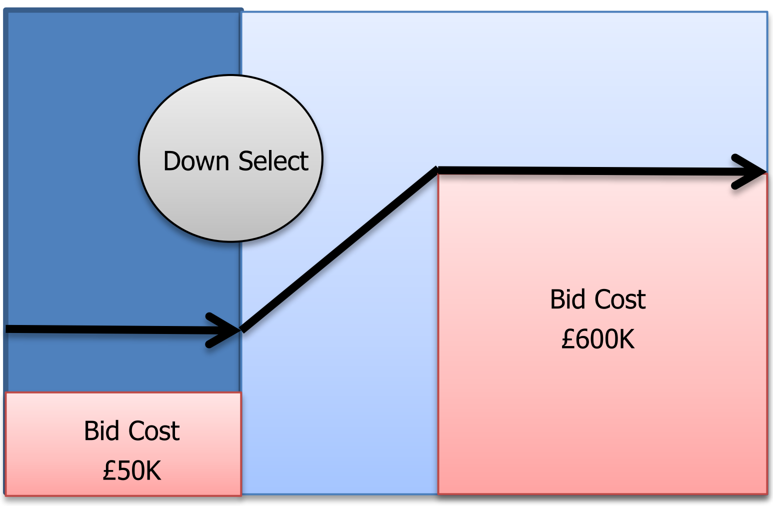
The ELEXON DCC bid costs would cost BSC Parties a minimum of £50k. As £50k is the estimated cost that would be incurred between implementation of P289 and the end of February 2013, when the four remaining DCC bidders would be reduced as part of a "down select" phase. If ELEXON were unsuccessful in their bid at the end of February/ early March 2013, then no further costs would be incurred. If ELEXON were successful then costs capped at £300k for external costs (such as professional advice and other requisite outgoings), and £300k for internal overhead costs (including personnel) would begin to be spent. A total risk of £600k.

The "down select" process selects a 'preferred bidder' and 'secondary bidders'. At this stage of the award the 'preferred bidder' would begin to ramp up costs in order to get ready to undertake the DCC role, with the secondary bidder moving much more cautiously and not spending as much. The Workgroup noted that whoever the preferred bidder were at this stage, there was a very high likelihood that they would win the DCC licence. Therefore if ELEXON began to spend the £600k capped costs it would be at a stage where there would be high strong likelihood of them being successful.

The Workgroup also noted on ELEXON's estimates, that if ELEXON were successful then Parties would receive the following payments back:

1) The full amount spent on the successful bid (between £50K and £600K) paid back over a maximum of 5 years, plus interest, or sooner if possible.
2) An estimated £12 million costs from defrayment of overheads (£1m per year of contract); and
3) Any dividends paid by DCCCo to BSCCo

The understanding of monies at risk can be summarised in the following diagram:



Q2. Do you believe there is Benefit in BSCCo's Participation in the DCC Bid Process?

The Workgroup considered that in assessing the benefits and drawbacks associated with BSCCo participating in the DCC bid process it was important to distinguish between considerations under the BSC and that affect participants as BSC Parties, which would inform the Workgroup's assessment of P289 against the Applicable BSC Objectives, and considerations relating to the wider industry, which it classed as ancillary effects that should be taken into account by Ofgem as part of its wider remit.

The Workgroup's views are summarised in the table below. Note that these views relate specifically to BSCCo's participation in the bid process, completely setting aside the success or failure of that bid.

Views on the amount of funding provided for under P289 varied among Workgroup members. Some believed that the maximum amount of £600,000 was not that significant in the context of the funding of the BSC generally, while others took the view that it was a significant amount when being placed at risk for no guaranteed benefit to BSC Parties.

Workgroup views on the effects of ELEXON participating in the DCC bid process	
Benefit	Drawback
Under the BSC None identified	**Under the BSC** • No benefit to BSC Parties; and • Cost to Parties with no guarantee of repayment
Outside the BSC • Additional competition in the DCC License tender process; and • Wider benefit to industry participants (including some that are also BSC Parties) of ELEXONs expertise	**Outside the BSC** Possible distortion of competition due to initial funding (this view not shared by the whole Workgroup)

Q3. Is there Benefit of BSCCo Undertaking the DCC Role?

The Workgroup's discussion of the effect of BSCCo undertaking the DCC role (via a subsidiary) is detailed below, under its considerations with respect to Ofgem's expansion criteria. Setting aside uncertainty around the outcome of an ELEXON bid, the Workgroup's views are summarised in the table below.

Note that the Workgroup did not consider the repayment of DCC bid costs a benefit as it would be simply a reimbursement of Parties money put at risk for non-BSC activities.

Workgroup views on the effects of ELEXON undertaking the DCC role	
Benefit	Drawback
Under the BSC • DCC activities and potential profits used to offset BSC overhead costs; and • ELEXON's involvement in DCC activities would facilitate effective interaction between the DCC and Settlement, and thereby potentially minimise any risk to Settlement arising from introduction of the DCC arrangements	**Under the BSC** • Possibility of degradation of BSC services due to sharing resource, lack of enforceable BSC service levels and potential for profit-based DCC activities (with potential financial penalties) to be prioritised over non-profit BSC activities
Outside the BSC • ELEXON's Settlement expertise would facilitate effective interaction between the DCC and Settlement	**Outside the BSC** None identified

Q4. Are the Initial Funding Arrangements Appropriate?

The majority of the Workgroup believed that the initial funding arrangements were not appropriate. They did not feel able to comment on the reasonableness of the costs as they had not seen a business plan, but noted that the magnitude of the costs was not the issue, but objected to the principle that Parties were going to be mandated into funding a bid that is not in the scope of the BSC. These members felt that investing in a bid (non-BSC activity) should be a choice rather than mandatory participation.

The Workgroup also noted that as well as being mandatory, some parties may not get any initial funding back, nor future revenue if they left the BSC prior to the loan being repaid or dividends arising.

The minority of the Workgroup believed that due to the fact that the costs were capped and the risk limited to around £50k for the first stage, that the potential benefits outweighed the risk and as such the funding arrangements were appropriate.

The Four Ofgem Expansion Criteria

The Workgroup considered the four criteria for ELEXON expansion set out by Ofgem, and the reasons set out in the P289 Modification Proposal to support the proposal's contention that P289 would meet these criteria.

The Workgroup's discussions against each point are set out below, and their views are summarised in the table below. The Workgroup agreed that P289 meets the expansion criteria, though they had some differing views with regard to criteria (a).

(a) BSC Parties should benefit from any diversification

The Workgroup considered the argument that creation of a new competitor/consolidator amongst the small field of central market arrangement delivery agents.

A Workgroup member questioned whether this would actually introduce a risk of distorting competition in the market. However, the Workgroup agreed that P289 would not introduce such a risk; noting that in fact the argument should be modified to reflect that P289 would create a new competitor in the DCC bid process (not central market delivery generally).

However, a Workgroup member did not believe there was any benefit associated with ELEXON participating in the DCC bid process as another competitor because the main benefit that ELEXON could particularly bring to the DCC process was providing input and expert advice on the BSC arrangements to ensure that the DCC arrangements developed interact effectively with Settlement and do not introduce a risk to Settlement. The member believed that ELEXON had already done this successfully and there was no quantifiable benefit from its further involvement as a competitor.

Similarly, this Workgroup member considered that in relation to the argument that P289 would mitigate risks of an adverse impact of Settlement arising from a DCC failure, in terms of the running of the bid process there was no further available benefit available beyond ELEXON's expert advice into the development of the arrangements. The member believed that other bidders would also have the ability and drive to minimise the risk of DCC having an adverse impact on Settlement.

A Workgroup member felt that there are BSC parties who have no interest in the DCC, nor that part of Settlement with which it will interact. The member felt that current obligations on Suppliers, who would be party to the DCC, surrounding data quality were sufficient to ensure that the DCC and BSC will interact successfully. Some BSC parties would therefore be mandated to invest in a business in which they had not interest and may receive no benefit from.

However, the majority of the Workgroup agreed that while any benefit would be difficult to quantify, more competition in the DCC bid process could be considered to have a generally beneficial effect on the bid process and also agreed that if ELEXON were successful in the bid process their incentive to protect Settlement and their Settlement expertise would tend to promote effective interaction between the BSC and DCC arrangements. However, a majority agreed this would only benefit BSC parties if ELEXON were successful.

In the case that ELEXON does become the DCC Licensee, there may be benefit to Parties in the form of defrayed BSC costs as a result of efficiency savings from shared overheads and dividends from DCC activities in future years.

(b) The arrangements should not place disproportionate risk on BSC Parties

The Workgroup agreed that the proposed P289 provisions would ensure that no disproportionate risk was placed on Parties as the Board would be obligated to have sufficient policies in place. However, the concern that P289 would result in a capped amount of BSC Parties money being placed at risk of non-repayment was a consideration against this criteria.

ELEXON noted the view expressed in Ofgem's open letter dated 21 November "Whilst the benefits of ELEXON's participation may not directly be a consideration for the BSC objectives, we consider that it should be able to identify synergies and generally improve the degree of competition to undertake emerging activities. Whilst we have no views on the relative merits of ELEXON to undertake this role in comparison with any other bidder, we consider that the existence of additional bidders should improve the extent of competition, benefiting the electricity industry and in principle putting a downward pressure on the costs the will be passed through to electricity consumers. Whilst these considerations may not be directly relevant to the furtherance of the BSC objectives, we consider that they are consistent with our wider statutory duties."

(c) Standards of Service under the BSC should be maintained

The Workgroup agreed that the proposed P289 provisions would ensure that standards of BSC service are maintained under expected circumstances. However, there was a concern that in the event that severe difficulties should arise with respect to DCC activities, BSC services could suffer due to ELEXON resource being diverted to resolve DCC issues, despite the fact that this would be inconsistent with the P289 Code provisions.

(d) ELEXON's BSC role should not give it any undue competitive advantage in a contestable activity

The Workgroup did not believe that ELEXON would have any undue competitive advantage in a bid for the DCC role under the provisions P289 would introduce, and noted that the Ofgem comment referring to the fulfilment of this condition being met is in the P284 decision letter.

How does the Modification meet Ofgem's expansion criteria?		
Ofgem condition	Workgroup view that criteria is satisfied	Counterview noted in discussions
(a) BSC Parties should benefit from any diversification	• Potential Cost reductions through the sharing of fixed overheads; • Participation in new business profits; • Creation of a new competitor in the DCC bid process; and • Mitigate risks of an adverse impact of Settlement arising from a DCC failure	• Cost reduction and benefit of DCC profit only if bid successful (uncertain benefit vs. definite cost); • DCC process already benefited from ELEXON input on Settlement, no further significant benefit available; and • DCC development, DCC bid process and competence of other bidders already mitigates risk to Settlement • Only benefit if BSC party when dividends arise
(b) The arrangements should not place disproportionate risk on BSC Parties	• Separate legal entities for non-BSC activities; • No pledging or transfer of assets; and • No guarantees	• Repayment of Parties' initial funding depends on success of bid (though funding is capped)
(c) Standards of Service under the BSC should be maintained	• No change to existing service standards; and • New obligation to ensure BSC is always properly resourced	• Possibility of degradation of BSC services due to sharing of resource and interaction with DCC activities (no specific concerns identified)
(d) ELEXON's BSC role should not give it any undue competitive advantage in a contestable activity	• Within-group services to be at arms-length on commercial terms; and • Ofgem acknowledged this test was met if tests (a) and (b) were met	None

9 Work Group Views against Applicable Objectives

Proposed Modification compared with current arrangements

The majority view of the Workgroup is that P289 Proposed Modification would not better facilitate achievement of the Applicable BSC Objectives compared with the existing baseline.

All of the Workgroup considered that Objective (d) was relevant to the consideration of P289. One Workgroup member believed that Objective (a) was relevant and another believed that Objective (c) was relevant.

Views Against

The majority of the Workgroup identified either no benefit or detrimental impact against Objective (d):

- No benefit associated with ELEXON participating in the DCC bid process because there is no further benefit to be realised in addition to the input ELEXON has already had into the development of the DCC arrangements through SMIP;
- Effectively introduces a mandatory obligation on Parties (traders, Generators and Suppliers) to fund non-BSC activities;
- Parties who leave the Code before 5 years wont get money back;
- Funding from Parties would be lost in the event of an unsuccessful bid;
- Introduces a risk around the delivery of BSC services - safeguards are not sufficient to ensure BSC service standards are maintained in all circumstances, while greater protection of BSC services would be delivered under the outsourced BSC services contract model, which is available under the existing baseline; and
- The potential benefits contended against Objective (d) are conditional on ELEXON being successful in a bid to become the DCC Licensee, and are therefore uncertain and cannot be considered as promoting Objective (d)

One Workgroup member identified a detrimental impact against Objective (a):

- Concern that P289 would expand the scope of BSC activities beyond that described in the Transmission License, impacting the Transmission License and removing focus from core BSC activities.

One Workgroup member identified a detrimental impact against Objective (c):

- The introduction of a risk to the maintenance of the standard of BSC service and an effectively mandatory obligation on Parties to fund non-BSC activities would not promote effective competition.

Views For

The minority of the Workgroup identified benefits against Objective (d):

- Potential benefit of ELEXON becoming the DCC Licensee in the form of efficiency savings and offsetting BSC costs with DCC dividends (thereby reducing Parties' BSC costs), and this potential benefit outweighs the definite (but capped and potentially repayable) cost of a DCC bid, and
- BSCCo's participation as DCC candidate adds competitive pressure to the process, which ultimately will better impact BSC Parties.

Impact on Transmission Licence

The Transmission Company Member noted that, at this stage, National Grid believes P289 is likely to impact the Transmission License, as it thought allowing ELEXON to do business outside the BSC is inconsistent with the License. They noted that they had been comfortable with P284, but they felt that P289 was allowing BSCCo to do things further outside of the BSC section of the licence. They referenced the addition of the Warm Homes Scheme into the BSC, where there had been a corresponding licence change. The Panel noted that it would be for National Grid and Ofgem to come to a view on this matter and agreed that it should be fed into Ofgem's process of making a decision on P289. The Transmission Company Member stated that the BSC is driven by it licence and cannot be separated from the licence.

ELEXON have received external legal advice regarding impacts on the Transmission licence which reads as follows:

"1. It is very arguable that the case can be distinguished from the Warm Homes Scheme. In that case, the scope of the BSC was extended to cover rules relating to the functions of BSCCo or a BSC Company in connection with that scheme. A corresponding modification was included in the transmission licence (i.e. C3(1A)) to reflect that extended scope. In the present case (P289) the scope of the rules in the BSC is not being extended; the BSC is simply being modified to authorise the creation and funding of another BSCCo subsidiary.

2. The transmission licence does not itself prescribe or limit the activities of BSCCo or its subsidiaries, beyond specifying certain functions which are to be included in those of code administrator. The restrictions on what can be done by BSCCo (and the related funding provisions) are all contained in the BSC.

3. I understand that paragraph 1(e)(iv) in condition C3 in the transmission licence ('not prevent .. the code administrator ... from operating [the warm homes reconciliation mechanism]') was included to prevent a subsequent BSC modification from being made which would conflict with carrying out those functions. It's not clear that it was strictly necessary to include that, or whether it is needed in the current case. If the Authority (and I note that in the Warm Homes case it was the Secretary of State) approves a BSC modification on the basis of which a BSCCo subsidiary were to be awarded the DCC contract, it must be doubtful whether a subsequent BSC modification could properly be approved by the Authority which had the effect of undermining the foundation for that contract, while the contract is in force."

Joint Ventures and Partnerships

The Panel enquired whether the ELEXON would enter into a joint venture with another party as part of the DCCCo bid, and if so what understanding was there of the potential risk, how ring fencing would be achieved and how costs would be allocated between ELEXON and its partner.

ELEXON clarified that, as discussed at the Workgroup and at previous Panel meetings, DCCCo is not and will not be a joint venture, and that ELEXON has not entered into any joint venture with any other organisation. The P289 legal text states that BSCCo is to be at all times the holder of all of the shares of DCCCo i.e. there can be no DCCCo joint venture partner (see clause C10.4.1 and the definition of "DCCCo").

ELEXON confirmed what it had previously stated to the Panel and the P289 Workgroup that it was working with Ernst & Young who were helping to support the bid. ELEXON reiterated that Ernst & Young are not being paid for their contribution, and so are working at no cost or risk to BSC Parties. If the ELEXON DCC bid is successful Ernst & Young will be the primary subcontractor of ELEXON providing specialist support and skilled resources particularly during the critical implementation phase.

ELEXON stated that some confusion may have arisen because they sometimes referred to Ernst & Young as a 'partner', "with a small p" just as they do to Logica because although they would technically be a service provider to the DCC. ELEXON feel it is important to have a total alignment of vision and values with any company it works with (this should not be confused with a JV partner who has more influence and control than a service provider). ELEXON and Ernst & Young share a long-term commitment to the industry and the smart transformation programme. The organisations also have strongly aligned corporate values, an independent service management ethos, and these aspects critically underpin the relationship between the two organisations.

The terms of the arrangements between Ernst & Young and DCCCo will be taken into account by the BSCCo Board when deciding whether to submit a response to the DCC ITA in January, and again when reviewing the business case for submitting a binding DCC bid. A binding bid will not be until the Best and Final Offer (BAFO) stage expected around July 2013. ELEXON noted some Panel members' desire to see the details of this contract, such as associated revenue agreements, but responded that it is not commercially possible, nor appropriate, to disclose widely the arrangements with Ernst & Young.

DCC Set up, Funding and Dividends

The Panel sought clarity on how profits/dividends of DCCCo would be apportioned, and what reassurance was available that BSCCo (and thereby Parties) would be the sole beneficiary of DCC activities. The Panel noted that:

- The Modification and the legal text specified that the DCCCo will be a wholly owned subsidiary of BSCCo, so there is nowhere else for dividends to go besides BSCCo (and any funds remaining with the DCCCo at the end of the DCC License term would also revert to BSCCo);
- BSCCo would therefore control 100% of DCCCo shares as sole shareholder, and while the DCC Board would have responsibilities to the DCC and would have strategic control over it, as sole shareholder BSCCo board would appoint the DCCCo board (as specified in the Modification and the legal text) and would have the same influence over DCCCo as BSC Parties' parent companies had over their own wholly owned licenced subsidiaries (subject to not causing it to be in breach of the DCC License); and
- The legal text specifies that DCCCo has to obtain the approval of BSCCo to DCCCo dividends.

It was also highlighted that the P289 legal text places an obligation on BSCCo to ensure that contractual arrangements are in place with DCCCo which, amongst other issues, must deal with a dividend policy and the allocation of shared costs (see clause C10.4.6).

A Panel member questioned how Parties could be assured that the dividend policy was fair. ELEXON explained that the directors of DCCCo will operate under fiduciary duties imposed by law which will require the directors to act in a manner which is most likely to promote success of the company for the benefit of its shareholders; in this case BSCCo who have 100% of shares.

It was noted that the Group had similar questions and wanted to put into the BSC a number of regulations that should be included in the dividend policy. ELEXON explained that whilst it sympathised with the idea, it was inappropriate to put that level of detail into the BSC as it would dictate Board policies, and Parties would have to trust the BSCCo board to make the right decisions.

The Panel noted that DECC are insisting on excellent governance for the DCC licensee and that the provision for external Auditors and 2 non-exec directors should provide extra support for Parties.

Estimation of defrayment

The Panel queried what consideration had been given to quantifying the costs that would be defrayed by ELEXON performing the DCC Licensee role. ELEXON referred to the Modification proposal which reported an estimate that £1m per annum would be defrayed, and the Workgroup had taken this into considerations in its assessment of P289.

What are the start-up costs?

A Panel member questioned how the start-up costs of the DCC would be paid for. ELEXON explained that the DCC Licensee can begin to collect funds from parties 1 month from award of the Licence, around August 2013, and would not have to pay any service providers until 2014. However, there would need to be some funding of working capital during this initial 1 month period, when the DCC Licensee is procuring resource but funds have not yet been obtained. DCCCo would obtain the funds via a working capital facility from a bank. There was no need for DCCCo to take on any structural debt to operate. A Panel member stated they wanted the work group to see the budget for this. ELEXON reiterated the Board has yet to see it as it is still in the planning stage.

Multiple loans

A Panel Member was concerned that the legal text might permit the BSCCo Board to award more than the capped £600,000 DCC bid loan to ELEXON/DCCCo by making multiple loans.

ELEOXN confirmed that the legal text permitted the BSCCo Board to use its discretion to make more than one loan. However, the total amount could not exceed the £600,000 which is capped (of which up to £300,000 could be spent on external costs and up to £300,000 could be spent on internal overheads).

Internal Overheads

A Panel member questioned where an extra £300K for internal overheads came, as they understood the proposal to be for £300K not £600K.

It was explained that the Modification proposal that had been presented to the BSC Panel on 13 December proposed to cap BSC Parties external costs at £300k. During discussion a Panel Member had stated that ELEXON's internal resource commitment should also be captured and similarly capped such that all BSC funding, whether internal resource or external spend, should be repaid to BSC Parties in the event that a DCC bid is successful. ELEXON confirmed that the internal resource was estimated to be £300k. Following the Panel's instruction, the Modification Proposal and draft legal text were amended (see paragraph C10.2.1) to state that aggregate costs are capped at £600k and that the actual aggregate costs incurred will be reimbursed (see paragraph C10.3) to BSC Parties.

The Panel questioned where the figure of £300K had come from and was there a resource plan. ELEXON confirmed that the figure was drawn from a budget and a plan that the BSCCo Board will consider as part of its decision to submit a non-binding DCC ITA response in January. If the BSCCo Board did not believe the plan or budget were sufficient then they would not approve the submission.

The Panel also queried what would happen to these costs if ELEXON progressed through the bid process but were ultimately unsuccessful. It was confirmed that, should that be the case, the money that had been spent up to that point would be written off.

Borrowing against other resource

A Panel member asked whether BSCCO could borrow money against other BSCCo resources, Intellectual Property Rights (IPR). ELEXON responded that BSCCo's ownership of IPR in all materials is unaffected by the legal text. Furthermore the legal text, whilst not reducing the existing restrictions, enhances protection for Parties by preventing BSCCo entering into any borrowing with DCCCo, including the giving of security.

What's the Underspend?

The Panel questioned what the underspend was and if it would cover the costs outlined in the proposal. ELEXON confirmed that it had returned £2.4 million to BSC Parties in its mid-year review, and highlighted that the underspend expected in April 2013 would cover the costs of P289.

Safeguarding resource

A Panel member commented that it was not clear how BSC service levels would be protected. This was one of the key issues for the Workgroup, the majority of which were concerned that the provisions around maintaining the BSC services were not sufficient to protect BSC service levels.

The Panel noted that under P289 the BSCCo Board has a role in safeguarding BSC service levels as it would have a new specific obligation (see clause C3.5.2 placed upon it to ensure that it always has available to it resource to ensure it can discharge its responsibilities under the BSC. DCC activities are not permitted to cause any degradation in BSC services.

Similar to the issue of dividends policy it is hard to place into the Code any more specific obligations on the Board and Parties should be comfortable that the BSCCo Board is acting in the interests of BSC Parties.

Potential alternative solutions

As noted in section 6 above, the P289 Group did not identify any potential alterative solutions during the Workgroup meeting. This was partly because the Group had developed the modification whilst discussing the solution during assessment. Therefore, in the absence of any radically different approaches to the Group's view of the P289 solution, the process of developing an Alternative was not required.

Subsequent to the Workgroup meeting a member suggested a potential alternative approach. However, aware of the time constraints of P289 timetable, and noting that the Group had discharged its terms of reference the member asked for his idea to be raised at the Panel meeting to seek Panel Members' opinions.

The Panel noted that only two of the Group responded to the suggestion. One member was unsure how workable the solution would be, but was willing to discuss it, and the other suggested a further potential solution, but no members provided any arguments as to why this alternative would be better than the proposed solution. The two potential solutions and the Panel debate are captured below.

Private Investors

The first potential solution had not been discussed at the Group. It was suggested that the solution would be the same as the P289 Proposed Modification, with the only differences being:

1. Initial funding for the DCCCo would be provided voluntarily by potential investors; and
2. Any returns made on the back of a successful DCC bid would be distributed to the voluntary investors in proportion to their investment.

The Group member felt that though this potential solution would decrease potential financial benefits for BSC Parties, it would not completely eradicate potential benefits for BSC Parties. Remaining benefits include:

- Cost reductions due to economies of scale and exploiting synergies;
- Ensuring the integrity of Settlement data; and
- Facilitation of innovation and creativity.

The P289 Group Chair noted that when considering the P289 Proposed Modification the majority of the Group believed that there was no benefit against objective (d) as:

1. ELEXON merely participating in the bid would not benefit BSC Parties; and
2. Any benefit from dividends and defrayment was only potential as it was conditional on winning the DCC bid

The majority of the Group also believed that there were 2 main detrimental impacts that outweighed any potential benefit (which in their view did not exist):

1. The risk around delivery of BSC services; and
2. Parties being mandated to partake in the bid

Whilst this proposed solution would address a main concern of Parties, regarding the funding mechanism, it would still leave the risk around the delivery of BSC services. Furthermore, it would reduce any potential benefits for Parties as there would be no dividend to pass back to BSC Parties.

In addition, a private investor could not be guaranteed to agree to utilise and therefore contribute to ELEXON overheads so the chance of defrayed costs also diminishes. On these grounds the Chair did not see how the Group could vote that this modification was better than the proposed modification, as the risk remained and yet any potential befits were reduced unless the majority of the group changed their views on the proposed.

BSCCo Board becomes DCCCo Board

The second potential solution was discussed at the P289 Work Group. The Group member suggested a solution where the BSCCo Board will be the DCCCo Board.

ELEXON explained that the issue had been raised at the Panel meeting on 13 December and at the P289 Workgroup meeting on 17 December. It believes that this is not a workable solution as the arrangements for the appointment of the directors of the DCC Licensee are set in the DCC Licence and/or the Smart Energy Code. Whilst it could be argued that requiring the BSCCo Board to also be the DCCCo Board may offer additional safeguards to BSC Parties, it is not in the gift of the BSCCo Board to determine these arrangements as to do so may cause DCCCo to be in breach of its Licence obligation.

The draft legal text provides a high degree of transparency regarding shareholder arrangements with DCCCo; these safeguards are both necessary and appropriate.

On Panel member suggested that there would be merit in discussing the concept, possibly altering the alternative so it was some joint Board members, or the Board plus the independents.

Panel Conclusions

The Panel discussed the two suggestions for possible other solutions .The Panel noted that during the Workgroup meeting the P289 Group did not identify any potential alterative solutions. This was partly because the Group had developed the modification whilst discussing the solution during assessment, and partly as a result of the timetable. In the absence of any radically different approaches to the P289 issue, the process of developing an Alternative was not required.

The Panel discussed the two suggestions for possible other solutions and noted the considerations around the Modification process, the detail of the suggestions, ELEXON's views on the viability of the suggestions and the likely interaction with Ofgem's expansion criteria.

A Panel member commented that they did not believe it credible to get a private investor and that if one was brought in, they would require far more control over DCCCo than any other model, with a suggestion that they would likely seek at least a 20% share and the right to appoint Board members. This would mean that the BSCCo board would not have complete control over the DCCCo. One Panel Member also felt that it is highly unlikely any private investor would want to invest in the DCC Licensee bid in its current form, especially as a minority shareholder.

A Panel Member believed that ideally consideration should have been given to the suggestions for other P289 solutions, although they did not believe the tabled potential solutions would be viable in their present state. The Members' concerns were not primarily that the suggestions were, or could be, superior to the P289 Proposed Modification, but that the Workgroup had not had sufficient time to consider all potential Alternatives because of the fast track timetable.

Another Panel member believed that not giving due consideration to Alternatives raised was not in line with the BSC and did not protect the interests of BSC Parties who may wish to raise Alternatives in future.

After substantial debate, the majority of the Panel accepted that provided the discussions on potential alternatives were included in the P289 report did not require further consideration by the Workgroup in the Assessment Procedure and could proceed to the Report Phase for consultation.

The Panel did request that ELEXON contact the P289 Work Group to get views on the potential solutions and include the potential solutions for comment in the P289 Report Phase Consultation, emphasising that industry views are sought on these suggestions and whether there are any other potential Alternatives that the Workgroup should have considered.

Views against Applicable Objectives

A Panel member highlighted that if there had been better direction from Ofgem and DECC then there wouldn't have been the need for such a Modification and the issues it has caused. They felt that in such circumstances all the Panel could do was to gather the available information and send it to Ofgem for consideration and to make reasonable judgment.

Another Panel member reiterated that it would be ideal to consider any alternative options to this modification, although noted that they were not convinced by the potential alternatives suggested so far. They noted that they had gained assurance from questions asked during the Panel meeting that DCCCo would be a wholly owned subsidiary with a single shareholder of BSCCo, and that it was not a joint venture. They also drew comfort that there was no loan required at the start of the bid process and that the spend was capped at £600K. They believed that trust in the BSCCo board was required and that the new provisions of P281 should help in that regard. They did not believe that there was an overly compelling case, but was comforted that Parties were not exposed to undue risk.

A further Panel member noted that this was all about the balance between potential risks and potential benefits to Parties. They believed that there were financial opportunities to invest and get a return. They highlighted the synergies between ELEXON's work and the role of the DCC and believed that with Settlement markets converging ELEXONs skills could be utilised more effectively. They also felt that new challenges would help ELEXON retain their staff and attract other capable staff. They noted that the potential risks, but felt that the safeguard of the BSCCo Board protecting resources and finances would mitigate such risks.

A Panel member stated that they had been strongly against P284 and the introduction of a contract model, but felt that this Modification was a much closer call. They noted three main issues. Firstly that it had been a stated benefit for the DCC if ELEXON entered the process, but felt that BSC Parties should not be sacrificed for the DCC. Secondly, they did not believe that the issue of finical risk was a big concern if the Board was wise enough. They noted that there may be concern that the Panel would be voting to spend Parties' money on a change that might not benefit all Parties, but considered that the Panel did this all the time with other Modifications that may only benefit part of the Industry. Thirdly, they noted the big issue of ensuring no cross subsidy in resources. They believed that bringing the DCC closer to the Panel would be beneficial as the Panel would have easier access to the information it might wish to know about the DCCCo, and that the bigger risk was of ELEXON losing staff if this opportunity was not given. They noted the tabled potential alternative solutions, but reiterated that they believed they were both impossible to progress and would be reluctant to continue looking for alternative options at this stage.

A Panel member stated that their main concern was that the views of the Group had not been adequately captured in the report or the legal text and that there hadn't been enough time to talk about alternatives. They noted that even for small Parties the costs involved in this modification were very small, but highlighted the principle that some Parties did not want to fund the bid at all regardless of the costs or potential wider benefits. They felt that despite the discussion and the assurances the joint venture issue was not clear enough and that more consideration should be given to the BSCCo Board being the DCCCo Board. They noted that the DCC Licence was not in a final form so it was difficult for the Panel, or BSC Parties to be clear on the risks of the business. The lack of clarity also meant that the Panel could not be certain that the DCC parties would not have greater control over the DCC governance, spend, etc. than the Board overseeing the DCCCo.

Another Panel member voiced concern over the transparency of the journey taken so far and that it had not be made sufficiently clear to Parties what the bid structure was and how the relationship with ELEXON and its partner in Ernst & Young worked on a contractual level. They noted previous comments that referred to resource plans, but questioned if these had been shared with the Panel and/or the Board and suggested that they should be circulated wider.

Another Panel member reiterated concerns about the Transmission Licence, but noted that was a concern for Ofgem and that this Modification should be progressed so that Ofgem can take a decision on the mater.

Conclusions

Overall the **majority** of the Panel believed that P289 better facilitated applicable **objective (d)**, and so should be **approved**. These Panel members agree with the views of the minority of the Workgroup that the potential benefits of P289 outweighed the potential risks.

The **minority** of the Panel believed that P289 did not better facilitated applicable **objective (d)**, and so believed it should be **rejected**. These panel members agreed with the views expressed by the majority of the Work Group against objective (d) that the risks outweighed any potential benefit and that Parties should not be mandated to fund a bid.

By majority, the Panel believes that P289 would better facilitate the Applicable BSC Objectives, and therefore initially recommends that P289 should be approved.