Stage 03: Assessment 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.

Modification Workgroup recommends:
Rejection 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

Contents

Any questions?

Contact:
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About this document:

This is the Assessment Report for P289. ELEXON will present this report to the Panel on 20 December 2012 on behalf of the P289 Modification Workgroup. The Panel will consider the contents of the report and the Workgroup's recommendations on the final page and agree an initial view on whether or not P289 should be approved.

The Assessment Report details the P289 solution, the impacts, costs, benefits and implementation activities to the extent the Workgroup has been able to determine them, and the views and considerations of the Workgroup in reaching its recommendations to the Panel.

Further Information

Attachment A to this report contains the draft BSC legal text for the P289 Proposed Modification. Further information and documentation relating to P289 is available on the P289 page of the ELEXON website.

Attachment A: Draft Legal Text for Proposed Modification

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 establish a subsidiary which can participate in the DCC bid process and, if successful, act as DCC. Dividends from DCC activities would be paid to BSCCo and used to offset BSC costs.

The Workgroup did not develop an Alternative Modification.

Impacts & Costs

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

Implementation

The P289 Workgroup recommends that if approved the P289 Implementation Date is one working day after an Authority decision is received.

The Case for Change

The majority of the Workgroup believed that P289 had the following drawbacks, which outweighed the potential benefits:

- No quantifiable benefit of ELEXON participating in the DCC bid process, further to the input ELEXON has already had into the development of the DCC arrangements;
- Obligates Parties to fund non-BSC activities;
- Funding from Parties would be lost in the event of an unsuccessful bid;
- May remove focus from BSC activities and introduces a risk to the delivery of BSC services and the maintenance of service standards; and
- Potential benefits are conditional on ELEXON being successful in a bid to become the DCC Licensee, and are therefore uncertain.

A minority of the Workgroup supported because they believed ELEXON's participation in the DCC bid process would add competitive pressure to the process which would benefit Parties and if ELEXON becomes the DCC Licensee Parties would benefit from efficiency savings and BSC costs being offset by DCC dividends.

Recommendations

The Workgroup's majority recommendation is that the P289 Proposed Modification should not be approved.

The majority of the Workgroup believed P289 would have either no benefit or a detrimental impact against Applicable BSC Objective (d).

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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 year[1]. 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.

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- **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:

- 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.

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' would most effectively meet the expansion conditions.

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 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 approved by Ofgem in September 2012.

On 27 November, ELEXON's Board concluded that, whilst ELEXON diversification will 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 the 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.

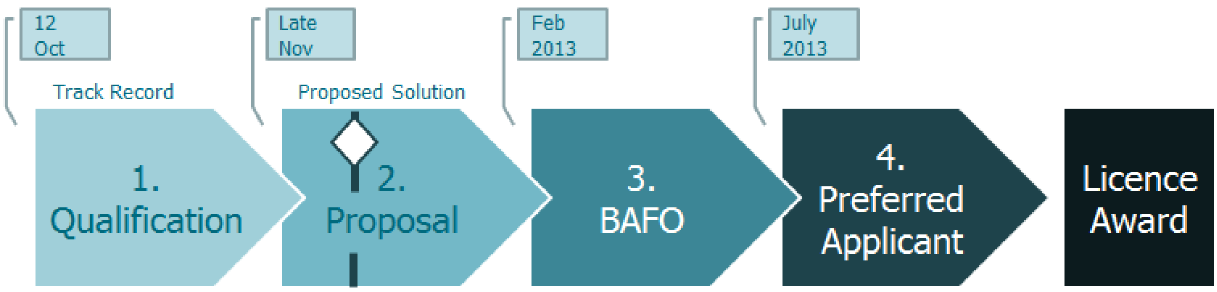
On the grounds that a Modification was limited solely to the DCC and SEC roles, and did not compromise delivery of the BSC services, of the five non-executive directors the recommendations were supported by four (including the Chairman), and hence the request from the BSCCo Board that the BSC Panel raise 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 process which has already started. ELEXON (as 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 request for Urgency. 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 the attendant risks and rewards. ELEXON have progressed a delivery model and has successfully demonstrated its track record of delivery in qualifying the first stage of the award process.

In recommending this Modification 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, and when necessarily higher 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 from the Licence Award date, that the DCC would need to cover its own operating costs prior to the first invoicing but these costs would be covered by a bank loan to the DCC).

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 Board believe that participation in the DCC bid would be beneficial to the industry. As a participant with a clear proposition, ELEXON enhances the competitive process and thereby contributes to developing the best solution and lower costs regardless of who wins. If successful, shared assets, overheads, processes and services will lower the costs of the BSC arrangements. ELEXON recognises that participating means committing BSC assets (and hence costs) but believe this will be outweighed by the benefits of enhanced competition.

The Identified Issue

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

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.

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 'Smart Co' 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 fund the DCC bid, but that funding has been capped at £300,000 external costs and £300,000 for internal overheads. 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 Smart Co profits would defray costs incurred by BSC Parties and any dividend given by Smart Co to BSCCo, as a result of the DCC work, would be distributed amongst Parties based on BSC funding share.

Key Features of Proposed Solution

Establishing a 'Smart Co' subsidiary

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

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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 Smart Co 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) Smart Co'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 Smart Co is awarded the DCC Licensee role, Smart Co will repay aggregate DCC Tender Costs in respect of that successful bid to ELEXON within a five year period. For the purposes of repayment, Aggregate DCC Tender Costs will comprise:

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

    (b) Smart Co'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 Smart Co 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 Smart Co will have no assets);

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

  (viii) ELEXON will be under an explicit BSC obligation to procure that Smart Co provides reports to ELEXON 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 Smart Co 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 Smart Co (i.e. Smart Co 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 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.

Impact on Transmission Company
P289 has no impact on National Grid in its roles as the Transmission Company or BSCCo Shareholder.

Impact on ELEXON
ELEXON will have the ability to participate in the DCC bid process via a subsidiary 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 recommend 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 is was ELEXON's understanding that three other tenderers had got through 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 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 Smart Co 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).

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

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.

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.

Establishing a 'Smart Co' subsidiary

DCC Dividends

The Workgroup noted that any dividends paid by Smart Co 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 Smart Co 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 kin to a contract. It was noted that though Smart Co 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, Smart Co 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.

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. 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.

A Workgroup member queried whether they was any risk that new paragraph C10.4.5, which obligates BSCCo not to cause Smart Co to breach its DCC requirements, would cause DCC obligations to take precedence or be prioritised over BSC obligations. ELEXON clarified that BSCCo and Smart Co would be separate legal entities with separate obligations, and this paragraph was solely to preclude BSCCo in its position as Smart Co shareholder from placing any requirements on Smart Co 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 Smart Co or by Smart Co 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). 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 be part of a narrowed field (the preferred bidder and one other) 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 Smart Co 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 five years.

Providing Security

The DCC bid process requires a financial security to support a bid. 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 more confidence to Parties if this ability was removed. The Workgroup believed that Smart Co should have no issue of gaining a bank Letter of Credit if it was in the bidding process.

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 Smart Co (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 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.

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 'Smart Co' 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.

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 solution set out in the Modification Proposal and addressing the defect identified by P289. 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.

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 finical penalties of Service Level Agreements would be a better incentive to deliver.

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:

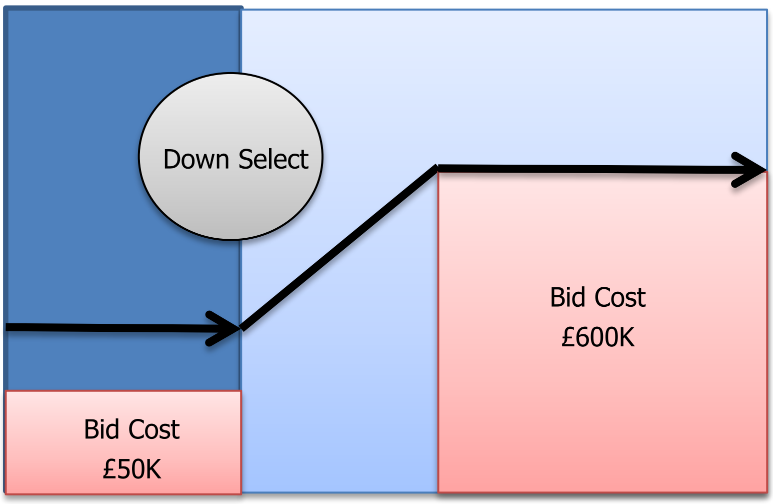
The ELEXON DCC bid costs would cost BSC Parties a minimum of £50K. As £50K is the estimated cost that would be incurred between implementation of P289 and the end of February 2013, when the four remaining DCC bidders would be reduced to two as part of a "down select" phase. If ELEXON were unsuccessful 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.

The "down select" process selects a 'preferred bidder' and a 'secondary bidder'. 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 likely hood that they would win the DCC licence. Therefore if ELEXON began to spend the £600K capped costs there would be a likely hood of them being successful.

The Workgroup also noted 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.
2) An estimated £12 million costs from defrayment of overheads; and
3) Any dividends paid by Smart Co 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)	**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 profits used to offset BSC costs; and • ELEXON's involvement in DCC activities would facilitate effective interaction between the DCC and Settlement, and thereby minimise any risk to Settlement arising from introduction of the DCC arrangements	**Under the BSC** • Some 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 so not because they disagreed with the magnitude of the costs, but on the principle that Parties were going to be mandated into funding a bid. These members felt that investing in a bid should be a choice rather than mandatory participation.

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 and noted 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.

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.

In the case that ELEXON does become the DCC Licensee, there would 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.

(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. 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.

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

The Workgroup agreed that the proposed P289 provisions would ensure that standards of service under the BSC 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 Code provisions introduced by P289.

(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	• 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
(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; and • Ofgem acknowledged this test was met if tests (a) and (b) were met	None

9 Workgroup 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 (generators and Suppliers) to fund non-BSC activities;
- 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.
- BSCCo's participation as DCC candidate adds competitive pressure to the process, which ultimately will better impact BSC Parties.

10 Recommendations

The P289 Workgroup invites the Panel to:

- AGREE an initial recommendation that Proposed Modification P289 should not be made;
- AGREE an initial recommended Implementation Date for Proposed Modification P289 of one Working Day after an Authority decision is received;
- AGREE the draft legal text for Proposed Modification P289;
- AGREE that Modification Proposal P289 be submitted to the Report Phase; and
- AGREE that ELEXON should issue P289 draft Modification Report for consultation and submit results to the Panel to consider at its meeting on 20 December 2012.