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*Your ref.*

October 2003

Mr Kyran Hanks  
Director, Gas Trading Arrangements  
Office of Gas and Electricity Markets  
9 Millbank  
London  
SW1P 3GE

Dear Mr Hanks

### **ELEXON Response to Ofgem Consultation on the Potential Sale of Network Distribution Businesses**

This is the response from ELEXON Limited to the Ofgem consultation document entitled, 'National Grid Transco - Potential Sale of Network Distribution Businesses', issued in July 2003.

#### **Introduction**

ELEXON welcomes the opportunity to comment on the issues raised in your consultation document. The document includes various options for the establishment of an agency to manage central activities in the gas market. One of these options is referred to as the 'ELEXON Model'. In view of this, and without providing an opinion of the desirability of such an option, we believe that it may be useful to provide some further information about ELEXON's structure, activities and costs in order to inform any further debate around that particular option. This response also describes the nature of the relationship between ELEXON and NGC, where particular parallels could be drawn with a possible agency model in gas.

#### **Overview of ELEXON**

ELEXON performs the role of the Balancing and Settlement Code Company (BSCCo) established under the provisions of the Balancing and Settlement Code (BSC) which came fully into force on 27 March 2001. ELEXON's principal function is to provide and procure facilities, resources and services required for the proper, effective and efficient implementation of the BSC. The BSC contains the rules and governance for the operation of the electricity balancing mechanism and the imbalance settlement process, as well as rules relating to competitive retail arrangements.

ELEXON is a not-for-profit, cost recovery based company. It is essential that it is, and is seen to be, unbiased and transparent in all its activities. In developing its role with interested parties, ELEXON continuously strives to demonstrate its balanced independence. The desire within the industry for such a level of independence was a key driver behind the establishment of the company in its current form. ELEXON is a wholly owned, but autonomous, subsidiary of NGC. Our constitutional documents (Memorandum and Articles of Association) provide appropriately limited objectives so as to minimise any scope for the company to owe any duties to NGC which would conflict with decisions appropriate to implement the BSC. This minimises the potential for any conflicts of interest that might exist should NGC (as the Transmission Company) carry out our functions directly.

## **Functions and Objectives**

ELEXON's main functions include:

- acting as the contracting party in respect of the main service providers supporting the balancing and settlement arrangements;
- supporting and managing the systems which facilitate balancing, settlement and retail competition in electricity supply, including the necessary communications networks;
- employing individuals involved in management of the BSC;
- providing support, advice and resources to the BSC governance arrangements;
- Managing change to the BSC arrangements;
- providing information and services to industry participants;
- monitoring compliance with the BSC and, where appropriate, taking steps to enforce its provisions; and
- managing financial and credit cover arrangements under the BSC, including billing.

The BSC obliges ELEXON to discharge its functions fully, promptly, fairly, economically, efficiently, transparently and in such manner as will promote effective competition in the generation, supply, sale and purchase of electricity.

## **Contracting Activities**

ELEXON subcontracts certain core activities underpinning the operation of the BSC to a number of central service providers, including activities to support the retail and wholesale market, imbalance and balancing mechanism settlement, reporting and other related systems and services. This approach allows ELEXON to manage these contractors on a commercial basis, with a view to minimising the costs payable by market participants while maintaining the quality of central services. There is provision for the service providers to be replaced or renewed via a competitive tendering process from time to time – providing additional performance incentives. The costs attributable to each central service provider are made transparent to the industry through ELEXON's annual budget and ongoing financial reporting. As the service providers are not directly involved in electricity trading, they have no incentive to block or unduly influence any potentially beneficial developments that may be agreed by the industry or regulator.

## **Governance Activities**

As noted earlier, one of ELEXON's key functions is to facilitate the governance of the BSC arrangements. This includes supporting the BSC Panel (the partly elected and partly appointed body with responsibility for oversight of certain aspects of the BSC) and providing resources to support the operation of the BSC Modification Procedures.

The management of change accounts for a significant proportion of ELEXON's activities. We strive at all times to ensure that all interested parties are given access to the modification procedures, and the opportunity to participate in the evaluation of proposals. Under the Modification Procedures, any party to the BSC may raise proposals. This includes the Transmission Company, which can also recommend that certain proposals be accorded urgent status (allowing it to discharge its obligation to maintain the integrity of the transmission system). However, under normal circumstances, the Transmission Company has no greater direct role in the development of the BSC arrangements than other participants.

We consider that ELEXON's independence is important to the effective and transparent operation of the Modification Procedures, allowing us to support impartial assessment of proposals against predefined objectives without any commercial incentive to influence particular outcomes.

ELEXON is also responsible for the full and timely implementation of all approved changes to the BSC arrangements. Once again ELEXON's independent role and arms-length commercial relationship with central service providers are critical to this activity.

### **Costs and Cost Control**

ELEXON's costs are completely transparent to participants and are set out in our published Annual Budget. The budget is approved by the ELEXON Board, which includes two directors drawn from the BSC Panel Members elected by the industry. The budget is set at a level to deliver the company's Business Strategy, which is formulated annually after consultation with all interested parties and which is approved by the Panel.<sup>1</sup>

Our costs comprise a combination of fixed and variable costs associated with the implementation and administration of the BSC. The budget currently includes recovery of costs incurred by ELEXON during the transition to NETA Go Live and sums associated with support that ELEXON is currently providing the DTI/Ofgem programme to introduce BETTA. We also administer certain costs relating to the funding of the introduction of NETA by Pool Members in 2001. We have no influence over this final category of pass-through costs, which are not included in the ELEXON budget and will reduce to zero at the end of a fixed recovery period.

Our current budget is as follows:

	<b>Year to March 2004 Budget £M</b>
1. ELEXON Operational	19.63
2. Demand-led	9.00
3. Contracted	31.98
<b>Ongoing BSC Costs Total</b>	<b>60.61</b>
4. NETA Funding	13.23
5. ELEXON BETTA Project	2.40
<b>Overall Total</b>	<b>76.24</b>
6. Administered	1.34

Item 1 in the table above covers the 'ELEXON Operational' costs i.e. those over which ELEXON's management is able to exert significant control, such as salaries, contract staff and overheads. Costs in this area vary depending on the decisions made by ELEXON and relate to those activities where ELEXON is best able to make efficiency improvements.

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<sup>1</sup> The BSCCo Business Strategy and Annual Budget can be found on the BSC Website ([www.elexon.co.uk](http://www.elexon.co.uk))

Item 2 covers the 'Demand-led' costs i.e. those relating to the BSC Modification process. ELEXON's management is able to exert little control over what modifications arise. However, ELEXON has a clear obligation to minimise the costs of Modification Proposals by efficient management of projects and associated contracts.

Item 3 covers the 'Contracted' costs i.e. costs of a more certain and predictable nature based on the various operational contracts that exist between ELEXON and its service providers. ELEXON's management has little control over some of these costs on a day-to-day basis but is able to improve efficiency via contract re-negotiation and careful use of variable services from its agents. As noted earlier, these contracts are subject to competitive procurement.

### **Further Information**

Given the similar scope of activities and objectives suggested for an equivalent agency in the gas market, we would be happy to provide any additional information that you might find helpful in view of our experience of establishing and operating ELEXON and the BSC arrangements. In particular, we note the proposed timetable for reform and could discuss the issues we faced and approach we took when we were required to set up in very tight timescales as part of the introduction of NETA.

We hope that you have found this response helpful. If you wish to discuss any of the points raised in this submission, in the first instance please do not hesitate to contact:

Gareth Forrester (gareth.forrester@elexon.co.uk) (020 7380 4159); or

Duncan Jack (duncan.jack@elexon.co.uk) (020 7380 4039).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Brian Saunders', with a stylized flourish at the end.

**Brian Saunders**

Chief Executive