Appendix 2 – BSCCo Interaction with UK Corporate Governance Code

SSE have spent time examining the Knight Review and coming to our own view on the current Elexon (BSCCo) governance arrangements, the flaws that exist and how some of those flaws could be remedied.

We agree with the Elexon (BSCCo) Board which, in turn, agrees with the conclusion of the Knight Review "that the current [BSC] governance arrangements are not fit for purpose".

The Board has identified four key problem areas[1] and this Modification seeks to address, directly, two of those four problems namely 'Lack of accountability' and 'Non-compliance with the UK Corporate Governance Code[2]'.

We observe that the Board's deliberations[3] would have been based on the September 2012 version of the UK Corporate Governance Code – and we have therefore made our comments below on the same basis. An updated version of the code was issued in September 2014[4].

We note that, according to the Financial Reporting Council, "Companies with reporting periods beginning before 1 October 2014 should continue to report against the September 2012 edition of the Code[5]" and, therefore, it's the 2012 version that would, in principle, 'apply' to Elexon. That having been said the FRC goes on to say that nevertheless companies "are encouraged to consider whether it would be beneficial to adopt some or all of the new provisions in the revised code earlier than formally expected". In light of these FRC comments we have, in addition, reviewed that version and (where appropriate) we provide comments below in respect of the 2014 document – where we do so we clearly identify it as such.

In addition we note that the 2014 version of the UK Corporate Governance Code builds upon the 2012 version in terms of enhancing the role for shareholders (amongst a number of changes). As such our comments below (based on the 2012 version) are still relevant and would be further enhanced by the changes brought in by the 2014 version.

We note that "The Board's biggest concern is that the current [Elexon] governance arrangements do not comply with the UK Corporate Governance Code".

We agree with the Board that this is a major (if not the biggest) concern.

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[1] As identified and detailed in Panel paper 225/20 https://www.elexon.co.uk/wp-content/uploads/2013/12/225_20_Moving_towards_new_ELEXON_Governance_Model_v1-0.pdf

[2] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf

[3] Published in time for the June 2014 Panel meeting.

[4] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

[5] https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

We agree with the Board that it is time to refresh the Elexon (BSCCo) governance to bring it in line, wherever possible, with best practice as set out in the UK Corporate Governance Code[6].

We agree with the Board that there are several aspects of the current Elexon (BSCCo) governance model that do not comply with the UK Corporate Governance Code. Our proposed solution would address these, and other, deficiencies and issues with the current Elexon (BSCCo) governance arrangements.

We agree with the Board that the Knight Report identified that the lack of clarity in the relationship between the Board and Panel manifests itself in a lack of accountability: it is difficult to know to whom the BSCCo Board is accountable, given the constraints imposed on National Grid as shareholder under the BSC. It is often unclear where final decisions lie, generating a feeling that the Board is not entirely responsible for the strategy and direction of the business. Our proposed solution would address these, and other, deficiencies and issues with the current Elexon (BSCCo) governance arrangements as well as bringing them into line with the UK Corporate Governance Code.

We agree with the Board that a concern is that any voting mechanism should take into account the large funding share of the vertically integrated companies, but balance this against a need to avoid giving undue control to any one Party or small group of Parties. Our proposed solution would permit the largest six parties to be outvoted by allowing other parties (than those six) to obtain a majority of the shares in Elexon (BSCCo).

<u>UK Corporate Governance Code</u>

Our proposed solution would be to make Elexon (BSCCo) accountable to its shareholders by issuing shares in Elexon (BSCCo) to BSC Parties in proportion to their annual funding share(s), allow those parties to release or receive additional shares, plus allow DNOs and New Entrants to obtain shares and thus allow those parties to freely act as the shareholders in the company as envisaged by the UK Corporate Governance Code.

This would make Elexon's (BSCCo's) governance entirely consistent with the UK Corporate Governance Code as it would ensure that there are shareholders in Elexon (BSCCo) who could exercise those roles and duties placed upon them (the shareholders) and the Board / Directors / Chairman / company in the UK Corporate Governance Code.

In this respect we note that that Code (pg 1) states that the "...first version of the UK Corporate Governance Code (the Code) was produced in 1992 by the Cadbury Committee. Its paragraph 2.5 is still the classic definition of the context of the [UK Corporate Governance] Code".

That paragraph 2.5 states that:-

> "*The **shareholders**[7]' role in governance is to appoint the directors and the auditors and to satisfy themselves* [the **shareholders**] *that an appropriate governance structure is in place. The responsibilities of the board include setting the company's*

[6] Initially the 2012 version, whilst being mindful of 'future proofing' in terms of the 2014 version.

[7] The word 'shareholder' is highlighted in bold for emphasis in this section.

strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to ***shareholders*** *on their stewardship. The board's actions are subject to laws, regulations and the* ***shareholders*** *in general meeting*".

In this respect we are also mindful of the Financial Reporting Council's 2011 review of the UK Corporate Governance Code and in particular the two principal conclusions one of which was "that the impact of **shareholders** in monitoring the Code could and should be enhanced by better interaction between the boards of listed companies and their **shareholders**."

Furthermore, the UK Corporate Governance Code goes on to state (pg 3) that "...in law the company is primarily accountable to its **shareholders**, and the relationship between the company and its **shareholders** is also the main focus of the [UK Corporate Governance] Code...."

In addition to these important matters the UK Governance Code also identifies a series of other important roles and duties for shareholders and the Board / Directors / Chairman / company which Elexon (BSCCo) would be able to comply with if this proposed solution were adopted.

These include:-

<u>Section A Leadership</u>

A1 The Role of the Board

"The board should set the company's values and standards and ensure that its obligations to its **shareholders** and others are understood and met."

"The chairman should ensure effective communication with **shareholders**."

"If exceptionally a board decides that a chief executive should become chairman, the board should consult major **shareholders** in advance and should set out its reasons to **shareholders** at the time of the appointment..."

A4 Non-executive Directors

"The senior independent director should be available to **shareholders** if they have concerns which contact through the normal channels of chairman, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate."

<u>Section B Effectiveness</u>

B4 Development

"The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this**,** directors should avail themselves of opportunities to meet major **shareholders**."

B7 Re-election

"All directors of FTSE 350 companies should be subject to annual election by **shareholders**. All other directors should be subject to election by **shareholders** at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. Non-executive directors who have served longer than nine years should be subject to annual re-election. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable **shareholders** to take an informed decision on their election."

"The board should set out to **shareholders** in the papers accompanying a resolution to elect a nonexecutive director why they believe an individual should be elected. The chairman should confirm to **shareholders** when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role"

Section C Accountability

C1 Financial And Business Reporting

"The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for **shareholders** to assess the company's performance, business model and strategy."

C2 Risk Management and Internal Control

"The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to **shareholders** that they have done so. The review should cover all material controls, including financial, operational and compliance controls"

C3 Audit Committee and Auditors

"[The Audit Committee] to make recommendations to the board, for it to put to the **shareholders** for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor"

"Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for **shareholders** to assess the company's performance, business model and strategy."

Section D Remuneration

D1 The Level and Components of Remuneration

“Remuneration for non-executive directors should not include share

options or other performance-related elements. If, exceptionally, options are granted, **shareholder** approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board.”

D2 Procedure

“The chairman of the board should ensure that the company maintains contact as required with its principal **shareholders** about remuneration.”

“The board itself or, where required by the Articles of Association, the **shareholders** should determine the remuneration of the non-executive directors within the limits set in the Articles of Association.”

“**Shareholders** should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.”

Section E Relations with Shareholders

E1 Dialogue with Shareholders

“There should be a dialogue with **shareholders** based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with **shareholders** takes place”

“Whilst recognising that most **shareholder** contact is with the chief executive and finance director, the chairman should ensure that all directors are made aware of their major **shareholders**’ issues and concerns.”

“The board should keep in touch with **shareholder** opinion in whatever ways are most practical and efficient.”

“The chairman should ensure that the views of **shareholders** are communicated to the board as a whole. The chairman should discuss governance and strategy with major **shareholders**. Nonexecutive directors should be offered the opportunity to attend scheduled meetings with major **shareholders** and should expect to attend meetings if requested by major **shareholders**. The senior independent director should attend sufficient meetings with a range of major **shareholders** to listen to their views in order to help develop a balanced understanding of the issues and concerns of major **shareholders**.”

“The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major **shareholders** about the company, for example through

direct face-to-face contact, analysts' or brokers' briefings and surveys of **shareholder** opinion."

"[footnote 25] Nothing in these principles or provisions should be taken to override the general requirements of law to treat **shareholders** equally in access to information."

E2 Constructive Use of the AGM

"For each [AGM] resolution, proxy appointment forms should provide **shareholders** with the option to direct their proxy to vote either for or against the resolution or to withhold their vote"

"The company should arrange for the Notice of the AGM and related papers to be sent to **shareholders** at least 20 working days before the meeting."

Schedule A

"Any new long-term incentive schemes which are proposed should be approved by **shareholders** and should preferably replace any existing schemes or, at least, form part of a well considered overall plan incorporating existing schemes."

Knight Review

Whilst, as the Board states, and we agree, compliance with the UK Corporate Governance Code is very important and our proposal deals (comprehensively) with this we have also sort to address a number of the Knight Review 20 recommendations.

In particular we believe that this Modification proposal will address, either directly or indirectly, the following Knight Review recommendations:-

1. There should be a single board to govern the BSC.

2. Board members should be appointed by the board for renewable three year terms. A nomination committee should recommend appointments to the board and recommend its size.

3. The chair should be appointed by the board on the recommendation of the nomination committee, subject to approval by Ofgem.

6. Board members should be remunerated.

11. BSC parties should have voting rights in accordance with their annual funding shares, with the right to appoint proxies.

12. All board members should retire annually and be eligible for re-election.

13. BSC parties should have the right to dismiss board members by ordinary resolution (a majority of votes cast).

14. The BSC report and accounts should be voted on.

15. The board should follow the UK Corporate Governance Code.

17. Any change to the constitutional provisions of the BSC, including the governance structure and the objects of the BSCCo, should normally be made only after approval by special resolution of the BSC parties (75 per cent of votes cast) and Ofgem approval which would be withheld if the authority believed that there was a danger that minority BSC parties or the consumer might be oppressed by the change. Ofgem should consider whether the transmission licence conditions should protect minority BSC parties. Ofgem would retain a reserve right to make any change, to cope with unforeseen circumstances.

For the avoidance of doubt we believe this Modification is ‘neutral’ with respect to the other Knight Review recommendations – it neither facilitates nor hinders those recommendations.