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24 July 2003

The National Grid Company, BSC Signatories and  
Other Interested Parties

Our Ref: MP No P115

Dear Colleague,

**Modification to the Balancing and Settlement Code (“BSC”) - Decision and Notice in relation to Modification Proposal P115: “Disapplication of Supplier Charges under certain circumstances”**

The Gas and Electricity Markets Authority (the “Authority”)<sup>1</sup> has carefully considered the issues raised in the Modification Report<sup>2</sup> in respect of Modification Proposal P115, “Disapplication of Supplier Charges under certain circumstances”.

The BSC Panel (the “Panel”) recommended to the Authority that Proposed Modification P115 should not be made, but in the event that the Authority determines that the Proposed Modification should be made, the Implementation Date should be:

- ◆ 1 January 2005, if an Authority decision is received by 1 September 2003
- ◆ 1 May 2005, if an Authority decision is received after 1 September 2003 and before 1 January 2004.

Having carefully considered the Modification Report and the Panel’s recommendation and having regard to the Applicable BSC Objectives and the Authority’s wider statutory duties<sup>3</sup>, the Authority has decided not to direct a Modification to the BSC.

This letter explains the background and sets out the Authority’s reasons for its decision.

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

<sup>2</sup> ELEXON document reference P115RR, Version No. 1.0, dated 12 May 2003

<sup>3</sup> Ofgem’s statutory duties are wider than the matters that the Panel must take into consideration and include amongst other things a duty to have regard to social and environmental guidance provided to Ofgem by the government.

## Background

Annex S-1 of the BSC defines certain areas for the measurement of the performance of Suppliers and their agents. These areas are called Serials. Each Serial has one or more levels of performance (Standards) that a Supplier is required to reach. There are a total of 11 Serials defined in the BSC, covering the quality of the data entering Settlement - including areas such as provision of consumption data for Non Half-Hourly and Half Hourly meters, installation of Half Hourly meters where required, etc - and the provision of information to Elexon for reporting and monitoring. Each Serial has a required standard.

Where a Supplier hub is not performing to the required Standard, that Supplier is liable to pay Supplier Charges. These Supplier Charges are not meant to be punitive. Instead, Annex S-1, paragraph 1.3.1 requires these charges to be "...a genuine pre-estimate of loss likely to be suffered by other Parties as a result of a failure by a Supplier to meet the applicable Performance Level...". Innogy plc considered that there were a number of circumstances, other than those detailed in the Section S3.3 (Supplier Force Majeure), in which the application of Supplier Charges may be inconsistent with their stated objective. In order to rectify this situation, Innogy plc submitted Modification Proposal P115, "Disapplication of Supplier Charges under certain circumstances", on 24 December 2002.

## The Modification Proposal

Modification Proposal P115 seeks to modify the BSC so as to allow the Panel to disapply part, or all, of the Menu of Supplier Charges for those periods where the application of such charges may be inconsistent with the status of the charges as "liquidated damages", or it may be otherwise unreasonable to apply them. The Modification Proposal suggests that such circumstances would include where:

- ◆ there is a known defect in the mechanism for calculating the charges and/or their redistribution
- ◆ the Performance Levels and Serials in respect of which the charges are applied do not take account of a recognised defect in industry process or arrangements
- ◆ performance has been significantly impacted by a failure of a previous Supplier(s) to comply with obligations under the BSC.

The justification for the Modification Proposal was that it would better facilitate achievement of the Applicable BSC Objectives<sup>4</sup> C3 (3) (c) and C3 (3) (d).

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<sup>4</sup> The Applicable BSC Objectives, as contained in Standard Condition C3 (3) of National Grid Company's ("NGC's") Transmission Licence, are:

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

The Proposer considers that in the circumstances suggested, payments due to “generic problems”, combined with a Supplier’s Monthly Cap, could dilute the resulting incentive on Suppliers to improve their own performance. Therefore the removal of “generic problems” from Supplier Charges will raise performance to a level where the effect of caps is avoided, and that this would be a positive incentive for Suppliers to investigate the cause of problems attributable to their own failures.

The Panel considered the Initial Written Assessment at its meeting of 16 January 2003 and agreed to submit Modification Proposal P115 to the Assessment Procedure. The Volume Allocation Standing Modification Group (“the Group”) considered the Modification over the course of three meetings (29 January, 20 Feb & 18 March 2003). Although there was widespread support amongst the Group and the consultation responses received for the principle of disapplying some Supplier Charges under certain circumstances, the Group was unable to formulate a sufficiently robust framework within the available time scale to allow legal text to be presented to the Authority. The Group therefore suggested that the Modification Proposal should not be made, but that work on the issue should continue using the expertise of the Supplier Volume Allocation Group. Additionally, it noted that the current provisions within the Code relating to Supplier Force Majeure may be applicable to the issue, but no mechanisms exist for either evaluating such claims or disapplying charges in a defined, non-arbitrary and transparent manner.

On 27 March 2003, the Panel requested provisional thinking from the Authority in order to obtain its view regarding the issues raised during the Assessment Phase. This provisional thinking was received from the Authority on 9 April 2003 and, in conjunction with the Assessment Report, was considered by the Panel at its meeting of 10 April 2003. The Panel unanimously recommended that Proposed Modification P115 should not be made and that the completed Modification Report should be presented at the Panel meeting of 8 May 2003.

ELEXON published a draft Modification Report on 17 April 2003, which invited respondents’ views by 28 April 2003.

### **Respondents’ views**

ELEXON received eight responses to the consultation on Modification Proposal P115. Seven responses (representing 44 Parties and 1 non-Party) expressed support for the recommendation that the Proposed Modification should not be made and the remaining respondent (representing 1 Party) provided a “no comment” response. The original Proposer was amongst the respondents that considered that the Proposed Modification should not be made.

Some respondents commented that it may be appropriate to review the issues involved in the Modification Proposal at a later date, once a number of changes that impact on Supplier Charges have been given time to take effect.

The respondents’ views are summarised in the Modification Report for Modification Proposal P115, which also includes the complete text of all respondents’ replies.

## **Panel's recommendation**

The Panel met on 8 May 2003 and considered the Modification Proposal P115, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Proposed Modification should not be made, but that in the event that the Authority determines that the Proposed Modification should be made, the Implementation Date should be:

- ◆ 1 January 2005, if an Authority decision is received by 1 September 2003
- ◆ 1 May 2005, if an Authority decision is received after 1 September 2003 and before 1 January 2004.

## **Ofgem's view**

Having carefully considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that Proposed Modification P115 would not better facilitate achievement of the Applicable BSC Objectives.

Ofgem's view is that Supplier Charges fulfil two roles:

1. Supplier Charges are defined in the BSC as "...a genuine pre-estimate of loss likely to be suffered by other Parties as a result of a failure by a Supplier to meet the applicable Performance Level...". The redistribution of these Charges to the other Parties that have suffered losses provides a compensation mechanism to ensure some Parties are not disadvantaged by the shortcomings of others.
2. Supplier Charges provide a financial incentive for Suppliers to improve their performance relative to other market participants against the standards set out in the BSC.

Modification Proposal P115 considered that a Supplier's ability to meet the performance standards required by the BSC could, in some cases, be affected by issues beyond the Supplier's direct control. The Group identified a number of such issues, including known industry operational deficiencies and problems caused by the underperformance of other market participants. The Group looked into whether any Supplier Charges levied in these circumstances should be disappplied.

Ofgem considers that the effectiveness of Supplier Charges is likely to be diminished if there were to be a mechanism for disapplication. Where a Supplier's performance is below the standards set out in the BSC for whatever reason, this will result in a financial cost to other industry participants. This cost would not be fully accounted for or reimbursed through the reallocation of monies from Supplier Charges if a proportion of those charges were disappplied.

In addition, it is Ofgem's view that the effectiveness of the incentives to try to resolve the underlying issues that cause underperformance would be eroded if a process was in place to disapply Supplier Charges.

Many of the performance standards already make accommodation for a degree of error by being set at less than 100%. Ofgem considers that this level of allowable error, determined by the industry, reflects the fact that there are issues in the market that impact on certain performance levels which a Supplier is not able to rectify. Change processes and mechanisms are in place to enable all Suppliers to propose modifications to these performance levels where they are thought to be inappropriate. Ofgem therefore agrees with the Panel's recommendation that Modification Proposal P115 should not be made.

In addition, Ofgem notes the impact of caps in diminishing both the incentives and the status of Supplier Charges as a genuine pre-estimate of loss (also defined in Annex S-1). A level of error that would result in a Supplier exceeding its cap will not be reflected fully in the Supplier Charges, although other participants will have incurred a financial loss. This loss will not be reflected or reimbursed. Ofgem notes that ELEXON are in the process of investigating the effects of caps and Ofgem looks forward to the results of this analysis.

### **The Authority's decision**

The Authority has therefore decided not to direct that the Proposed Modification P115, as set out in the Modification Report, should be made and implemented.

Having regard to the above, the Authority, in accordance with Section F1.1.4 of the BSC, hereby notifies NGC that it does not intend to direct NGC to modify the BSC as set out in the Modification Report.

If you have any questions, please contact me on the above number.

Yours sincerely,



**Iain Osborne**

**Director of Supply**

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