

Nick Simpson
Director, Industry Codes
Ofgem
9 Millbank
London
SW1P 3GE

27 March 2003

Dear Nick,

As you will be aware, at their meeting on 13 March 2003 the Panel noted that the Volume Allocation Standing Modification Group (VASMGS) were having difficulty identifying a viable solution for Modification Proposal P115, and decided that the Authority's provisional thinking should be sought, in accordance with Section F2.6.10(b) of the Balancing and Settlement Code ("the Code"). The P115 Assessment Report is due to be provided to the Panel for consideration at their meeting on 10 April 2003 and access to the Authority's provisional thinking would aid the Panel in their deliberations at that time. A copy of the Interim Report presented to the Panel on 13 March 2003 is attached to this letter. Since that meeting the consultation responses have been received and a further Modification Group held. This letter reflects the latest findings in relation to this Modification Proposal.

P115 raises a number of difficult assessment issues. When P115 was first presented to the Panel it was noted that there were aspects of the definition of P115 that were unclear, which would have supported the initial use of the Definition Procedure. However, it was believed that in order to gain a good understanding of the underlying issues, it was necessary to start activities associated with the Assessment Procedure and to start assessing some aspects of the Modification Proposal. This approach has proved very beneficial to the VASMGS and also explains the range of issues considered by the group and the progress made.

There is widespread support, within both the VASMGS and also the consultation responses, for the principle of being able to disapply charges under certain circumstances. The VASMGS recognise that the combination of Performance Levels already set to less than 100%, and provision for claiming Supplier Force Majeure (SFM)¹, also provides a degree of protection to Suppliers for the problems that Modification Proposal P115 claims to address.

However, it is not clear how any disapplication of charges could be achieved (for either SFM or P115) in a manner that is defined, non-arbitrary and transparent. The complex rules and supporting systems are defined by a precise set of algebraic rules in Annex S-1 of the Code, which do not themselves provide an explicit facility to disapply charges. This limits the ability of the VASMGS to define a simple solution, i.e. one based on the existing provisions in Section S-1,

¹ Provisions for claiming SFM (S3.3) are included in the performance section of the Code. However, this is restricted to covering the grounds and process for submitting an initial claim. The Code does not define how the subsequent processing of this claim should proceed, how the merits of a claim are evaluated, and how a successful claim could result in changes to the Supplier's original charges, in a manner that is equitable to other Suppliers and also recognises that charges are a pre-estimate of losses that will still exist. In addition the defined grounds and timetable are not limited and could support a wide range of claims.

and yet the VASMG also recognise the materiality does not appear to support major changes to amend the algebra (and supporting systems) in Section S-1.

The Panel and VASMG recognise the importance of Supplier Charges in compensating Suppliers for the poor performance of other Suppliers and the incentives these deliver to all Suppliers to improve performance and data quality. However, they also recognised this must be done both fairly and accurately.

The VASMG have explored a number of scenarios for events that may be considered outside a Supplier's control. The VASMG experienced difficulty in determining whether the key factors were justifiably within the control of the Supplier. For many cases that appear outside a Supplier's control, arguments can also be proposed for why the Supplier could have addressed this issue earlier, or that it is not sufficiently material to be disappplied. In this respect the VASMG note that Supplier Charges are themselves an estimate and that if an amount is to be disappplied, then ideally it should be more significant than the accepted error in the original estimate.

The VASMG also believed the root cause of each generic problem should be resolved, and have submitted a number of potential problem areas to the Supplier Volume Allocation Group (SVG) for their further consideration. However, the VASMG recognised some of these problems are more fundamental and relate to the Change of Supplier / Change of Agent initiative. The VASMG have recognised that even if this initiative is successful, then it will take a significant period of time for the benefit to be realised, and that in the meantime Supplier Charges are being applied.

The VASMG have been unable to identify a viable solution, or even determine a non-arbitrary and transparent manner in which the existing provisions for SFM should be applied. They recognised that further, potentially significant, work is required to clarify the existing provisions before it is possible to determine whether a modification against those provisions would better facilitate the achievement of the Applicable BSC Objectives.

As a consequence of the above, the view of the VASMG is that the Assessment Procedure should be completed with a recommendation to reject the Modification Proposal. However, the VASMG also believe that additional work should be undertaken to clarify the existing provisions for SFM, and specify how these should be applied to Supplier Charges. The need for a Modification Proposal should be considered once this is complete, and further experience has been gained in assessing the materiality of Supplier Charges.

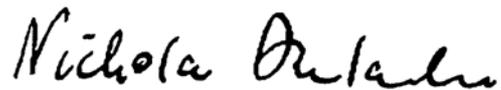
Having come to this conclusion, the Panel and VASMG would welcome the Authority's view regarding the amount of protection that should be contained within the Code to allow Suppliers to avoid paying Supplier Charges for matters outside their direct control. In particular whether:

- a) the combination of Performance Levels set to less than 100%, and provision for claims of SFM, is sufficient to protect Suppliers from charges that are not "reasonable in all circumstances", or whether the Authority believe more sophisticated controls may be justified;
- b) it is appropriate to disapply Supplier Charges that arise from the performance of a previous Supplier and their Supplier Hub. Alternatively is it considered that a new Supplier is solely responsible, using other techniques within the Performance Assurance Framework to ensure they are able to achieve the defined Performance Levels at the appropriate time;

- c) as Supplier Charges apply to Settlement Days in the past, is it appropriate to consider allowing charges to be challenged², and subsequently disapplied, for a defined period following receipt of any charges. If so, as Supplier Charges are being calculated that go back to 1 April 2001, should Suppliers be allowed to challenge these charges if the challenge is made within the defined period.

If you have any queries then please do not hesitate to contact me on 0207 380 4251 or Gwilym Rowlands, the lead analyst for P115, on 0207 380 4373.

Yours sincerely,

A handwritten signature in black ink that reads "Nichola Durlacher". The signature is written in a cursive, slightly slanted style.

Nick Durlacher

BSC Panel Chairman

CC: David Edward
Paul O'Donovan

² For reasons other than challenging the source of the data used in the calculations, in accordance with S-1 4.1.22.