Meeting name VASMG - Issue 6 (2)

Date of meeting 18 September 2003

Paper Title IDEAS FOR CONSIDERATION

Purpose of Paper For Discussion

1. INTRODUCTION

1.1 This paper provides further details on the various ideas suggested by the VASMG at its first meeting on Issue 6 to allow for further discussion.

1.2 The paper is structured in two parts:

- explaining the effects of removing the current Supplier Charges (SCs) technique, and
- further details of the ideas suggested at the first meeting of the VASMG measured against specific criteria

1.3 This paper should be considered in conjunction with the paper entitled 'Introduction to Corrective Performance Assurance Techniques' included as Attachment 1.

2. EFFECTS OF REMOVING CURRENT SUPPLIER CHARGES

2.1 The VASMG may conclude that the current SCs are not an effective technique within the PAF and could propose their removal. Briefly this would have the following effects:-

Effect on the PAF:
SCs are one of the few corrective techniques available under the PAF. The PAF should be balanced against the Risks to the trading arrangements. If they are removed the PAF will be in imbalance and would require either:-

- A new technique to compensate for the loss; or
- Reinforcement of the PAF using the remaining techniques

It would be an opportune moment to replace SCs with a technique that is a strong incentive to gain compliance by Parties.

Effect on Suppliers:
SCs are meant to be a genuine pre-estimate of loss. If the current SCs were removed each Supplier would no longer be liable for the 'liquidated damage' but neither would any Supplier receive any funds.

It is worth noting that Suppliers will still be obliged to meet the relevant performance standards.

A few Suppliers try to validate their SCs, no SCs would mean that Suppliers would not need to commit resource to this activity. It is possible that some Suppliers will have constructed contracts that back off their SCs to their Party Agents. A revision to contracts may be required as a result.

Effect on Trading Parties:

SCs collected are redistributed to all Parties with a Funding Share. Parties would not receive funds from the SCs collected if charges were removed. It is worth noting that Parties with a negative Funding Share are currently liable to pay as a result of SC processing.

Effect on performance:

It is questionable as to whether SCs act as any kind of incentive to perform to the relevant standards. Historically the greatest charges are accrued for failure to achieve the NHHRF standard. Performance against NHHRF has only recently begun to improve (improvement is very gradual) and this has been driven by an industry wide project that involves all Suppliers).

Effect on the BSCCo

The removal of SCs would mean resource currently applied to the processing, maintenance of the stored procedure within PARMS, checking of Scs and distribution of SCs would not be required.

3. IDEAS SUGGESTED AT VASMG ISSUE 6 (1)

3.1 At the first meeting of the VASMG to consider Issue 6 the VASMG suggested a number of ideas for a corrective technique and asked ELEXON to provide a page on each idea for further discussion. Each idea is provided under the following headings, as brief overviews, for consistency:

- Definition
- Effect as an incentive
- Impact on PAF
- Ease of Implementation
- Associated Operational Issues
- Stand alone technique
- Transparency

3.2 Idea 1 - Performance Naming

Definition:

The idea is to see whether the PAB or Panel could exercise powers that could see the naming of Parties who are under performing. The idea is that the threat of public or industry naming is a strong incentive to encourage Parties to perform to the required standards.

Effect as an Incentive:

It has previously been the belief of the PAB and the Panel that the ability to name participants would be a strong incentive to gain their compliance.

A consultation was recently carried out on the possibility of using peer comparison of Supplier performance relating the levels of erroneously large EACs/AAs. All except one respondent opposed the idea, this may suggest that the threat of naming would be a strong incentive (it should be noted however that respondents felt the erroneously large EAC/AA issue is not easily understood by non Parties).

Such a technique could arguably be used if the criteria for naming was defined within the Code. It is worth noting that the Code provides for Parties to be named publicly when they enter Level 1 and Level 2 Credit Default.

What is the impact on the PAF:

If it is believed that the ability to name is a strong incentive for Parties to perform it should therefore be a strong corrective technique that can supplement the other PAF techniques. It would also comfortably fill any gap, should Supplier Charges be removed.

Is it easily implemented:

Any form of naming is most certainly going to require a Modification. Whether the technique is peer comparison, naming the best performers/worst performers or public naming of Parties escalated to PAB the ELEXON website could be used as the medium for naming. It is not difficult to implement any additional page(s) to the website. Rules would need to be defined as to what the qualification for naming are, the timescales for remaining named and possibly even define a mechanism for appeal?

What are the associated operational issues:

This technique would require the use of the ELEXON web team to update the website and an ELEXON representative to process the data as required. Aside from performance of the server it is not envisaged any other operational difficulties would be met.

Is it a stand alone technique:

It is possible to combine this technique with other PAF techniques (e.g. PAB escalation).

Is it transparent:

This technique would need to be defined in the Code and rules surrounding its use made clear therein. There would be transparency of the technique itself with visibility of the output on the website.

3.3 Idea 2 - Excluding errant Suppliers from the reallocation of their own charges

Definition:

The idea is to prevent Suppliers from receiving their share of their own charges. An implication of this is that the principle of Supplier Net Liability is removed and that the Suppliers charges are capped, rather than the Net Liability as at present.

Effect as an Incentive:

This proposal can not be considered in isolation, if it were to be implemented it would require significant changes to the capping and redistribution mechanism. If redistribution were to be amongst the other NHH Suppliers in a GSP group, as at present, then due to the complex interaction between a Supplier's charges, NHH Energy Share and Cap the effect of this proposal could be ineffective and disproportionate. The proposal has an adverse effect on larger suppliers, regardless of their level of performance. The Capping process would need to be revisited as a Suppliers Net Liability excludes the funds they would receive from their own charges

There is no extra incentive provided by this proposal to improve HH performance as the majority of the reallocation is dependent on the Supplier's NHH Energy share, so a purely HH Supplier has no extra incentive to improve performance.

It may be argued that the current method of redistributing Supplier Charges results in some compensation being made to NHH Suppliers in proportion to their NHH energy share. This is reasonable because of the effects of underperformance on Group Correction Factor. This proposal could move away from the rationale behind this aspect of SCs.

What is the impact on the PAF:
The PAF is not impacted overall as this idea is a minor variation on an aspect of the current SC rules. The idea does not seem to add to or remove from the effectiveness of the SC technique within the PAF.

Is it easily implemented:
Implementation of this proposal would add an extra degree of complexity to the system, and inevitably to the testing required.

What are the associated operational issues:
Until the redistribution mechanism is determined it is not possible to be able to quantify this.

The checking of Supplier Charge reports already constitutes a significant amount of operational time and this proposal would increase that considerably. It would also require the creation of several new reports to facilitate this process. The summary reports visible to participants are already complex, and this proposal would add an extra level of detail.

Is it a stand alone technique:
Yes, as it is a variation on the current SCs

Is it transparent:
As this is merely a tweak to the current rules the same issue of lack of transparency of liabilities and redistribution still exists.

3.4 Idea 3 - Remove Caps from current SCs

Definition:
The idea is to remove the current capping mechanism from SCs and make Suppliers liable for the full set of charges they accrue.

Effect as an Incentive:
This idea is a variation on the current theme of SCs. The threat of increased costs should be an incentive for Parties to achieve the performance standards as to not do so could incur significant costs. Additionally a good performing Party will enjoy the benefits of the redistribution of potentially unlimited funds.

However, this idea cannot be progressed without some revision to other aspects of the current SCs regime. If caps were simply removed they would have the potential to put small to medium Suppliers out of business. Most serials take the volumes of energy into account when applying a charge, however Serial 10 does not. A Supplier who fails to submit one serial (or omits one agent for a submission in error) for all GSP groups for 10 working days is currently liable for £3,277.20. Similarly an incorrect submission for Serial 9 could prove extremely costly for a Supplier.

To carry out this technique we would need to re-investigate whether the charges qualified as a genuine pre-estimate of loss.

Another consideration is that under current rules non Supplier Trading Parties with a negative Funding Share contribute to the SC funds. Increased costs for distribution would mean increased costs for these Parties.

What is the impact on the PAF:

There would be no immediate impact on the PAF as nothing has changed, however it could be argued that the technique would be more potent with increased liabilities.

Is it easily implemented:

This idea would require significant revision to the current stored procedure for processing PARMS. It may not be possible to make the changes within the current PARMS and would therefore require any new PARMS to process these changes. This would also require PARMS to operate two sets of rules for SCs and the change would need to take account of resubmissions (currently indefinitely). This idea would also not resolve the issues surrounding the lack of any mechanism to disapply charges.

You could not implement this solution on its own without other revisions to the current SCs framework. This would be a significant piece of work.

What are the associated operational issues:

The current PARMS may not support any such revisions and it is not clear how different rules surrounding SCs would be applied in practice.

Is it a stand alone technique:

Yes, as it is a variation on the current SCs.

Is it transparent:

This variation on SCs could be argued to be more transparent as each Supplier could make a better estimate at what their charges would be (as it is not obscured by Caps). However Suppliers would still have no idea what their overall liability would be as they would not know what other Suppliers had accrued.

3.5 Idea 4 - Make Party Agents Parties to the Code

Definition:

This technique would mean that all Supplier Agents were forced to become Parties to the Balancing and Settlement Code. This idea was first discussed as a way of ensuring that problems associated with the cost of poor quality of data entering Settlement fell where it was caused. It is assumed that this option would involve clauses being drafted into the Code that would provide a genuine pre-estimate of loss and that this financial amounts involved would be billed to the Supplier Agent.

Effect as an Incentive:

This does not seem to strictly qualify as an incentive under the PAF. The reason this option has arisen is because of the difficulties that some Suppliers have in gaining compliance from their Agents. There may also be an inability to pass costs back to the Supplier Agents via their own contractual route. This idea would require primary legislation and subsequently the appropriate incentives on these new Parties would need to be built into any revised trading arrangements.

What is the impact on PAF

Impact on the PAF would need to be evaluated as a result of any revised trading arrangements.

Is it easily implemented

The following issues have been identified with this option:

- **How would Party Agents be mandated to become Parties to the Code?**, Suppliers and Generators of electricity currently have a licence obligation to become Parties to the Code. Party Agents are not licensed; they are certified as being able to carry out their role with particular combinations of other agents and Suppliers in particular Grid Supply Point (GSP) Groups. The provision of Supplier Agent services is not a licensable activity. It would probably require primary legislation to make it so.
- **Rights of Supplier Agents –** If a Supplier Agent were to be mandated to be Party to the Code, What type of Party would they be and what rights would they have? Parties currently have the powers to carry out activities such as raising of Modification Proposals, votes in the Panel elections.

What are the associated operational issues

These would need to be considered against any revision to the trading arrangements.

Is it a stand alone technique?

n/a

Is it transparent

n/a

3.6 Idea 5 - Allocate costs of the PAF

Definition:

This idea proposes to allocate the costs of the PAF to participants. The PAF costs approximately £6M per year. It comprises several different techniques, some of which are more effective than others at addressing certain types of under performance. Most of these techniques are scaleable: one can do more or less EFR, TA, Audit, etc with consequential changes in both costs and benefits.

One option for the VASMG to consider is a model where the quantity of each PAF technique (and the balance between them) is adjusted periodically (for example annually or bi-annually]) so that the performance issues in the market can be most effectively addressed. For example, the nature and volume of issues in the market might mean that 10% more EFR and 20% more TA would be appropriate. It might be that the following year 5% more EFR and 10% less TA would be appropriate. This approach would make the PAF self tuning and more effective in addressing performance issues in the market.

In principle, it would also allow BSC Parties, either through the Panel or PAB, to have a more direct say in the level of expenditure on the PAF and how such expenditure is targeted. However, ELEXON would need to retain day to day management control of how the budget was spent within consistent with the defined budget and priorities. Further, it is logical to assume that BSC Parties would only approve expenditure on the PAF up to the level of benefit they expected to achieve. This benefit, in turn, could be argued to represent the avoided loss due to under performance by Suppliers. Hence, it might be argued that the act of agreeing the targeted budget in effect constituted making a "genuine pre–estimate of loss", which could form the starting point for the calculation of liquidated damages, if so desired.

Alternatively, the PAF could be positioned as a set of BSC services "paid for" by Suppliers to a degree reflective of their degree of underperformance.

Effect as an incentive:

The incentive on Trading Parties is not great as they already bear the costs of the PAF within the overall ELEXON costs. However there may incentive to correct performance and avoid the additional costs of extra PAF activities. There may also be a danger that Parties may dispute the costs as there would have to be an element of subjectivity applied to where the additional PAF techniques needed to be applied.

What is the impact on the PAF:

The PAF could be strengthened if the costs of having the additional techniques applied incentivises participants to perform to avoid this activity.

Is it easily implemented:

The PAF costs are currently recovered from all Trading Parties in proportion to their Main Funding Shares. If the performance in the market overall were excellent, and performance were uniform across Suppliers, it could be argued that one would only require the most basic PAF. It would be reasonable for the costs of this to be recovered via the Main Funding Shares as is currently the case. It would also be reasonable that anything over and above this most basic PAF – required because of Supplier underperformance – be paid for by the underperforming Suppliers via Supplier Charges.

Assume the basic PAF costs £5M per year. Also assume that there were significant data quality issues in the market. The PAB, or Panel, could decide (possibly following advice from ELEXON) that certain aspects of the Audit should increase at a cost of £0.25M (to aid detection) and that EFR should be increased at a cost of £1M (to aid resolution). The Supplier Charges unit costs associated with underperformance would be set to recover this £1.25M incremental cost.

The advantages of this model are that:

- The quantity of PAF techniques employed and the balance between them can be tuned to most effectively address current issues;
- The cost of addressing performance issues is paid for by those underperforming – so providing an incentive to achieve the standards;

There does not have to be any complex redistribution of Supplier Charges.

One other consideration is that charges would most probably have to be applied against Suppliers for the performance of their agents, as we may be unable to bill agents directly for this activity. This may lead to dispute from Suppliers.

What are the associated operational issues:

Any new charging mechanism for the additional costs would have to be agreed, there is also an impact on when any charges would be levied. If these are revised periodically we are in danger of losing payment should any Party go into default under the Code.

Is it a stand alone technique:
By its essence it would involve the other 'directly measurable' PAF techniques

Is it transparent:
Yes – as the costs should be available to all within ELEXONS budgeting.

3.7 Idea 6 - Revisit Redistribution

Definition:
The idea is to change the method for redistributing the funds collected by Supplier Charges.

Effect as an Incentive:
This idea is a variation on the current theme of SCs. If it is proposed that poorly performing Parties receive less funds from the total collected then the threat of increased costs should be an incentive for Parties to achieve the performance standards as to not do so could incur greater costs than at present. Additionally a good performing Party will enjoy the benefits of the redistribution of funds.

To carry out this technique we would need to reinvestigate whether the charges qualified as a genuine pre-estimate of loss as the reallocation is presumed to return monies to those Parties (mainly NHH Suppliers) who have suffered from the poor performance.

What is the impact on the PAF:
The PAF is not fundamentally changed as this is a variation on the current technique.

Is it easily implemented:
This idea requires work to recalculate what a genuine pre-estimate of loss would be and also what constitutes a more appropriate means of reallocating funds. This idea would also not resolve the issues surrounding the lack of any mechanism to disapply charges.

You could not implement this solution on its own without other revisions to the current SCs framework. This would be a significant piece of work.

What are the associated operational issues:
The current PARMS may not support any such revisions.

Is it a stand alone technique:
Yes, as it is a variation on the current SCs.

Is it transparent:
Suppliers would still have no idea what their overall liability would be as they would not know what other Suppliers had accrued and the capping process remains.

3.8 Idea 7 - Change the Serials to which SCs apply

Definition:

The idea is to revise the set of Serials to which SC are applied. It is suggested that the charges may not apply to the appropriate Serials that incentivise the correct areas of performance, especially that surrounding CoS/CoA which may be causing issues that Suppliers need to be properly incentivised to correct.

There are a number of Serials being proposed under P99 that the industry has agreed to be a useful set of Serials for monitoring. Only a few of these Serials apply directly to Supplier performance and these are the Serials to which SCs currently apply. The simplest way to agree a charging mechanism would be on simple measurements that are not easily disputed or subjective measures. It is difficult to see what Serials are to be introduced, or that could be proposed, that lend themselves to this.

Effect as an Incentive:

The level of the charge will dictate whether the idea becomes effective as an incentive, a low charge on what industry deems to be a key Serial would be an ineffective incentive. If key Serials can be identified and charges applied that are of sufficient incentive then we may have a stronger SC technique than present.

What is the impact on the PAF:

The PAF would retain a SC technique, but only if the charges were simple and transparent, as well as being of sufficient size to gain compliance, would the PAF be strengthened.

Is it easily implemented:

Any idea would need significant work to establish what Serials should be measured and how they should be applied. Any new SCs should use a new framework for charging/distributing SCs to avoid the issues relating to the current mechanism.

What are the associated operational issues:

These will be dictated by any solution.

Is it a stand alone technique:

Yes, as it is a variation on the current SC technique.

Is it transparent:

Only if the whole rules surrounding the application of any new SCs are revised.

3.9 Idea 8 - Charge on % energy Serials only

Definition:

The idea is, in essence, that for each supplier the % of energy in settlement based on estimates would be used as the key measure for use in deriving Supplier Charges.

The use of estimated rather than actual data in settlement leads to uncertainty and possible inaccuracy in settlement. Fundamentally, one of the primary objectives of the PAF is to ensure that this uncertainty is at an acceptable level. Thus % energy settled on actuals is a key performance indicator for settlement.

Again, taking another perspective, there are many obligations placed on Suppliers in the BSC. The current model measures compliance with many of them and levies Supplier Charges against a subset. A simpler alternative is to choose a metric that is symptomatic of underperformance against a number of non compliances – a key performance indicator – and levy Supplier Charges against this. The percentage of energy settled on estimates is by far the most revealing metric of underperformance.

The advantages of approach are that:

- It would derive Supplier Charges directly from what is probably the single most important performance indicator.
- Suppliers would be incentivised to address the broad range of issues (including data quality) that prevent settlement based on actuals;
- The application of Supplier Charges would be very simple;
- Calculation of Supplier Charges following a transfer of Supplier Id would be simple (as the metrics would be settlement date based).

Effect as an Incentive:

Data quality issues invariably present Suppliers with difficulties in achieving settlement based on actuals. This is because issues at any point in the end to end process – from registration through to provision of aggregated data by the Data Aggregator to the SVAA – often manifest themselves as settlement based on estimates. This form of SCs would only be effective if the values associated with the SCs were of sufficient value to ensure compliance.

What is the impact on the PAF:

This technique is similar to the current SC regime, only by changing the value of the charges associated would the PAF be stronger.

Is it easily implemented:

Yes, although the application of these charges would require significant thought.

What are the associated operational issues:

The idea would require an investigation into what qualifies as a genuine pre-estimate of loss and subsequently the reallocation of those funds, else we will have to deal with the same issues and constraints of the current SCs regime and system.

Is it a stand alone technique:

Yes, as it is a variation on the current SC technique.

Is it transparent:

Only if the rules surrounding the charging and redistribution are fundamentally changed from the current SC regime.