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The National Grid Company, BSC Signatories and
Other Interested Parties

Direct Dial: 020 7901 7355

10 May 2005

Our Ref: MP No P157

Dear Colleague,

Modification to the Balancing and Settlement Code ("BSC") - Decision and notice in relation to Modification Proposal P157 "Replacement of current Supplier Charges rules".

The Gas and Electricity Markets Authority (the "Authority")[1] has considered the issues raised in the Modification Report[2] in respect of Modification Proposal P157 "Replacement of current Supplier Charges rules".

The BSC Panel (the "Panel") recommended to the Authority that

- Alternative Modification P157 should be made,
- Proposed Modification P157 should not be made,
- an Implementation Date for the Alternative Modification of 1 December 2005 if an Authority decision is received on or before 3 March 2005, or 1 March 2006 if the Authority decision is received after 3 March 2005 but on or before 23 June 2005
- an Implementation Date for the Proposed Modification (in the event that the Authority determines that the Proposed Modification P157 should be made) of 1 December 2005 if an Authority decision is received on or before 3 June 2005, or 1 March 2006 if the Authority decision is received after 3 June 2005 but on or before 23 September 2005, and
- the proposed text for modifying the Code, as set out in this Modification Report.

Having considered the Modification Report and the Panel's recommendation and having regard to the Applicable BSC Objectives[3] and the Authority's wider statutory duties,[4] the Authority has decided not to direct a Modification to the BSC in line with Modification Proposal P157.

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[1] Ofgem is the office of the Authority. The terms "Ofgem" and the "Authority" are used interchangeably in this letter.

[2] ELEXON document reference P157RR, Version No. 1.0, dated 05 November 2004.

[3] The Applicable BSC Objectives, as contained in Standard Condition C3(3) of 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 of the GB 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;

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

This letter constitutes notice by the Authority under section 49A Electricity Act 1989 in relation to the direction.

Background

A supplier's poor performance in a number of activities can lead to other suppliers incurring costs. For example, where a supplier in the Half-Hourly (HH) or Non-Half-Hourly (NHH) market submits inaccurate consumption volumes, this will increase the likelihood that other NHH suppliers will be allocated additional energy through the process of Grid Supply Point (GSP) Group Correction Factor. A number of different methods are used to derive the level of accuracy in consumption volumes and these generally focus on the certainty of accuracy as a proxy for the level of accuracy itself. Concerns have been raised, since the qualification of the BSC Audit opinion, that poor data quality, particularly in the NHH market, impacts the ability of suppliers to settle energy to a tolerable level of accuracy.

Within the BSC are certain measurable performance standards (Serials) contained in Annex S-1 which are applied to the activities of Suppliers. Each Serial has one or more Standards which a Supplier is required to achieve. Where a Supplier is not performing to the required Standard on certain Serials, Supplier Charges accrue to reflect the increased uncertainty of the accuracy of settled energy volumes. As noted above, Supplier Charges are designed to provide a system of compensation through which the loss caused by one or more Supplier's sub-standard performance can be reimbursed to the Parties settling energy in that GSP Group suffering the loss in question. Supplier charges should constitute a genuine pre-estimate of the loss (GPoL) caused by the Supplier not performing to the required standards. This loss is mainly incurred, for example, through additional volumes of energy being allocated to suppliers through Group Correction Factor or the cost of correcting poor data received by other parties.

Serials cover a range of issues, including the appropriate reporting of data in the NHH market. Following its deliberations, the Volume Allocation Standing Modifications Group (the Group) considered that, to the extent that Supplier Charges are intended to be a corrective technique, they have been unsuccessful at improving supplier performance. A number of reasons have been suggested, including the complexity of the current arrangements, the difficulty in relating performance improvements to reductions in charges and the tardiness of invoices.

Following the discussions of the Group on Issue 6, which raised concerns as to the appropriateness of the current rules and their effectiveness as a corrective technique, EDF Energy raised P157 on 5 January 2004 with the intention that it should modify the BSC so as to replace the current Supplier Charges rules in Annex S-1 of the BSC with a robust set of rules that adhere to the proposed criteria set out in Issue 6.

The P157 Initial Written Assessment was presented to the Panel at its meeting on 15 January 2004. The Panel submitted P157 to a two-month Definition Procedure. The Definition Report was presented to the Panel at its meeting on 11 March 2004. The Panel decided to submit P157 to a three-month Assessment Procedure, with an Assessment Report scheduled to be presented

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d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements as described in paragraph 2 [of the Transmission Licence].

[4] 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.

to the Panel at its June 2004 meeting. During the initial stage of the Assessment Procedure, the Group issued a consultation document to the industry detailing its initial conclusions regarding the Proposed Modification and a number of potential alternative solutions.

At its meeting on 13 May 2004, the Panel requested that the Group present an Interim Report at the next Panel meeting to enable the Panel to seek provisional thinking from the Authority. An Interim Report was presented and the request for provisional thinking was made. The Authority delivered its provisional thinking on 25 June 2004 such that it could be considered at the July 2004 Panel meeting. At this meeting the Panel also considered a second Interim Report submitted to it by the Group, which contained the Group's views on the Authority's provisional thinking.

The Panel directed the Group that the Proposed or Alternative Modification should have the following features:

- the Genuine Pre-estimate of Loss (GPoL) for Serial SP08a should include a suitable calculation for in-house Supplier costs to correct bad data,
- the charge re-distribution method should be linked to the target Standard and hence support its attainment, and be continuous and monotonic, and
- there should be no cap on a "basket" of Serials, although a cap on individual Serials was acceptable. The Group issued a second assessment consultation document to industry to finalise the composition of any Proposed and Alternative Modification. The Group then decided the components of the Proposed and Alternative Modifications and agreed its provisional recommendations to the Panel.

The Group issued a third Interim Report to confirm the details of the Proposed and Alternative Modifications it had developed and to specify the additional work it required to complete the Assessment Procedure. The Panel agreed a one month extension to the Assessment Procedure such that an Assessment Report would be presented at the October Panel.

In September the Group issued a third assessment consultation document to allow participants to consider P157 on a GB basis following BETTA Go-Active on 1 September 2004. The purpose of this consultation was for all participants to consider P157 on a GB basis as well as for new Scottish participants to consider P157 against the Applicable BSC Objectives.

Finally, the Group issued a fourth consultation in relation to an issue regarding use of Final Reconciliation (RF) data under the P157 Alternative Modification Proposal.

The Assessment Report was presented to the Panel at its meeting on 14 October 2004. At this meeting, the Panel submitted P157 to the Report Phase.

The Modification Proposal

Modification Proposal P157 seeks to modify the BSC so as to improve the quality of the data coming forward into Settlement, through the introduction of a Supplier Charges mechanism that is easily understood and creates an incentive on suppliers to submit actual meter readings into Settlement.

Certain features were shared by the Proposed Modification and the Alternative modification:

Chargeable Serials and GPoL

The Group considered legal advice regarding the requirement to set the charges that are applied to the Serials such that they are reflective of the genuine pre-estimate of loss incurred by other Parties. It determined that any type of Supplier Charges regime that has a correlation between degree of under-performance and amount charged is a liquidated damage - no matter how simple or complex that correlation – and that the liquidated damage must be a genuine pre-estimate of the loss caused as a result of under-performance.

The Group considered the elements contributing toward the GPoL at great length and was diligent in ensuring that any cost which could be construed as a penalty, rather than a GPoL, was excluded from the calculation. Deliberations on this topic often turned on the difficulty of estimating the GPoL accurately. Nevertheless, the Panel made recommendations to the effect that, where reasonable, costs should be included within the GPoL, rather than excluded from it.

The Proposal follows the current arrangements by seeking to apply Supplier Charges on Serials SP01, SP02, SP04, SP08a, SP08b & SP08c. The GPoL for the former three would be charged on a £/day basis, the latter three on a £/MWh basis.

SP01 & SP02 focus on the delivery of routine performance reports which contribute to the timeliness of the Performance Assurance Reporting and Monitoring System (PARMS) data provision. Under the current Supplier Charges regime they are charged on the basis of £28 per day, per GSP Group, where these performance reports have not been correctly submitted. The Proposal's provisions would apply a Supplier Charge of £20 per day.

SP04 is concerned with the installation HH metering at sites which have NHH metering inappropriately installed. It requires that suppliers install correct metering within 3 months of the metering system qualifying for mandatory HH metering. Not having the correct type of metering installed is considered to increase the level of uncertainty of the accuracy of consumption of those metering systems. Currently, a charge of £2.95 is payable per day for each metering system which requires a HH meter but where one is not installed within 3 months. Under the provisions proposed by P157, this charge would be reduced to £1.66 per day.

Serial SP08a requires suppliers to settle a certain proportion of their allocated energy based on Annualised Advances (AAs) rather that based on Estimated Annual Consumptions (EACs). Where a NHH supplier settles all of its energy on based on AAs, this provides a level of certainty that the volume of energy attributable to their customer portfolio is relatively accurate. Conversely, where a lower proportion of NHH energy is settled based on AAs, this decreases the level of certainty of accuracy. Supplier Charges are accrued at R3 and Final Reconciliation (RF). The current charge per MWh settled on EACs below the relevant performance standard is £0.15 and £1.62 respectively.

Factored into the current level of Supplier Charges for this Serial is an estimate of the financial impact that this reduction in certainty is likely to have on other parties within a GSP Group. The Group conducted analysis into relative inaccuracies. It identified that the volume of energy settled by a supplier in the NHH market varies only a small amount from the initial reconciliation to the final reconciliation compared to the change in the proportion of that energy settled on AAs. The analysis showed that, over the 14 month reconciliation period, the percentage of energy settled on actual readings changes considerably[5] but that this results in only a small change in the amount of energy attributed to each supplier. This implies that estimates of consumption are reasonably accurate when considered from the point of view of a supplier's whole portfolio. The loss that other parties suffer through Group Correction Factor as a result of poor performance relating to SP08a was therefore considered to be small and the proposed associated charge was £0.11 per MWh.

Added to the analysis for the SP08a charge, the Group gave consideration to the in-house supplier costs of correcting bad data associated with a meter point that a supplier acquires from a competitor. This factored in the time that suppliers reported it takes to correct errors and derived a charge of £0.09 per MWh.

The total calculated value of the volume of energy that is uncertain, incremental central costs relating to poor performance and in-house costs to correct bad data resulted in a proposed charge for Serial SP08a of £0.20 per MWh at RF. It proposes removing the charge at R3. Further analysis of the relationship between uncertainty and inaccuracy in relation to this Serial is being undertaken as part of Modification Proposal P182.

SP08b requires suppliers to settle 99% of consumption above 100kW based on AAs at SF and the First Reconciliation Run (R1). This Serial is for compulsory HH metering (MIST). SP08c requires suppliers to settle 99% of consumption below 100kW based on AAs at RF – this Serial is for non compulsory HH metering (MOST). Under the current provisions the Supplier Charges for both Serials are charged at £1.77 per MWh. Similar analysis was conducted into the level of the HH charge for Serials SP08b and SP08c. However, this had the effect of a significant increase in HH charges, partly as a result of the different ways that estimates are calculated in the HH market. The proposal and the alternative calculate £3.21 per MWh as the charge.

Capping

The current basket of Supplier Charges are capped based on the supplier's proportion of the GSP Group's take, ie they apply to the total of all the applicable Serials. P157 would cap charges accruing from only Serials SP08a, SP08b and SP08c, and be based on 1% of the Supplier Take multiplied by the Credit Assessment Price (CAP) in any GSP Group.

Peer Group Comparison (PGC)

PGC is a benchmarking mechanism which uses comparative performance data to derive an ascertainable standard. Originally, many members of the Group and the Panel considered that a modification to the Code would be needed if PGC was to be introduced to provide a performance incentive.

The Group considered the five most important problems contributing to the qualification of the BSC Audit[6], and concluded that although none could be appropriately remedied via Supplier Charges, some could be dealt with via PGC. Initially work was undertaken by the Group in order to determine how this might be progressed, although it was later confirmed that PGC

[5] If meeting the performance standard for SP08a, this percentage could increase from 0 to 97% over the 14 month reconciliation.

[6] Including the inaccurate energisation status of metering systems, processing of erroneous EAC/AA NHH, erroneous values of Unmetered Supply (UMS) NHH, the inadequate clearance of exceptions and backlogs in the HH market, and the inadequate clearance of exceptions and backlogs in the NHH market.

could be included by amending the Balancing and Settlement Code Procedures (BSCPs),[7] as section J 1.4.2(d) of the BSC already provides the ability to publish this information. The Group determined that evaluation of PGC within the scope of P157 was unnecessary as this matter could be more appropriately pursued via another route.

<u>Redistribution</u>

Different redistribution mechanisms are suggested under the Proposed and Alternative modifications. The Proposed modification uses a redistribution methodology that is identical to the current methodology. This redistributes 90% of the charges in each GSP Group to NHH suppliers based on their NHH market share in that area. The remaining 10% is redistributed amongst Trading Parties based on their Main Funding Shares.

The Alternative Proposal features a different redistribution mechanism. As before, 10% of the money from charges is redistributed to Trading Parties and 90% to NHH suppliers. However, under this proposal, suppliers would only receive their share of the redistribution, based on their NHH market share, where their performance in that area in relation to Serial SP08a is above the average performance. Where their performance is below average, they will not receive any compensatory payments through the redistribution of charges. Suppliers performing above the required standard of 97% would receive a larger share of the redistribution. This, it was considered, would provide an incentive for suppliers to increase performance above the average and above the standard.

<u>Implementation Date</u>

The implementation date suggested for both the Proposed Modification and the Alternative Modification was 1 December 2005 or 1 March 2006, although this was dependent upon the date of an Authority approval, should a direction to change the BSC be issued.

It was the view of the group that the Proposed Modification would better facilitate the achievement of Applicable Objectives (c) and (d) in comparison to the current baseline because;

- revision of the GPoL would make the process more cost reflective since the charges would be more accurate,
- the existing cap calculation was not considered justifiable and has been removed. An amended cap has been introduced – having no cap was seen as being a barrier to entry to Parties. Whereas a cap that is inappropriate and is invoked frequently is detrimental to competition since Parties would not have an incentive to improve data as their maximum liability is not significant, and
- Supplier Charges are supposed to be compensatory and the current redistribution methodology achieves this.

A minority did not believe that the Proposed Modification better facilitated the achievement of the Applicable BSC Objectives as;

- they considered the mechanism would not provide an incentive because much of the monies charged are returned through redistribution,
- the level of compensation under P157 would be of a magnitude less than the current level of compensation, and

[7] BSCPs exist beneath the BSC and contain the detailed provisions which are intended to give effect to the intention of the provisions of BSC.

- the proposal makes gross assumptions in order to derive and apply average charge rates for poor performance against Serials, particularly SP08a, b, c. The proposed charges disregard individual Supplier data accuracy performance, and assume an average accuracy of estimated data based on a limited sample of doubtful validity. This could give charges which are over generous for some Parties and penal for others, and for Half Hourly (HH) Suppliers this discrimination would be greater than under the current arrangements due to the higher proposed rates.

It was the view of the Group that overall the Alternative Modification better facilitated the achievement of the Applicable BSC Objectives as compared to both the current baseline and the Proposed Modification. Participants in the Modification Group considered that;

- revision of the GPoL would make the process more cost reflective since the charges are more accurate,
- the existing cap calculation was not considered justifiable and has been removed. An amended cap should be introduced with the same justification as the Proposal,
- the Alternative Modification should act as an incentive on Parties to address poor data quality issues, mainly as a result of the amended redistribution,
- the disincentive for a new Party to enter the market is reduced since there is less uncertainty in the market as the Alternative Proposal should improve performance (amended redistribution should provide an incentive),
- the efficiency of BSCCo and industry should increase as less time should be required to be spent on improving poor performance and dealing with data quality issues, and
- that whilst the overall level of compensation is generally less than the current baseline, under P157 Alternative it is better targeted.

A minority considered that the Alternative Modification did not better facilitate the achievement of the Applicable BSC Objectives as;

- it does not create a clear, transparent and predictable incentive which was the defect identified by the Modification Proposal,
- the Alternative redistribution could be discriminatory by nature, and thus would not meet the Applicable Objectives,
- the solution represents a shift away from charges being related to a GPoL and the use of liquidated damages to a system of fines and incentives making the proposal is more complicated,
- the industry has yet to see the benefits from the new Serial measures from P99, so it is difficult to calculate if P157 is better than the current mechanism in place,
- the proposal makes gross assumptions in order to derive and apply average charge rates for poor performance against Serials, particularly SP08a, b and c. The proposed charges disregard individual Supplier data accuracy performance, and assume an average accuracy of estimated data based on a limited sample of doubtful validity. This would give charges which are overgenerous for some Parties and penal for others, and for HH Suppliers this discrimination would be greater than under the current arrangements due to the higher proposed rates,
- the additional cost of the Alternative Modification outweighs any benefits it might have.

Responses to ELEXON Consultation

ELEXON published a draft Modification Report on 19 October 2004, which invited respondents' views by 12pm on 29 October 2004. Seven responses were received. Five responses (representing 24 Parties and 1 non-Party) expressed support for the provisional recommendation of the Panel to the Authority that P157 Alternative Modification should be made, 2 responses (representing 24 Parties) opposed this recommendation. Five responses (representing 24 Parties and 1 non-Party) supported the provisional recommendation of the Panel to the Authority that the Proposed Modification should not be made, 1 response (representing 14 Parties) opposed this recommendation, whilst the remaining response (representing 10 Parties) expressed no opinion.

Of those respondents which agreed with the recommendation of the Panel, three commented that Alternative Modification P157 would better facilitate Applicable Objectives (c) and (d). One of these respondents considered the Alternative Modification offered an incentive to address the issue of data quality in settlement. Another noted that the Alternative could be expected to improve performance and data quality thus reducing uncertainty in the market and, as a result, less time and money would need to be spent on improving performance. This respondent noted that it did not support the use of the current redistribution mechanism under P157. The fourth respondent offering comment in support of its view noted the changed redistribution of supplier charges suggested under the alternative modification offered an improved incentive.

Of those respondents disagreeing with the recommendation of the Panel, one considered that the Alternative Modification would not better facilitate the Applicable Objectives on the grounds that the GPoL calculation is flawed, that the new Supplier Charges are too high in the Half Hourly market, too low in the Non Half Hourly market, and that the redistribution mechanism proposed under the Alternative Modification is inequitable and represents a shift away from the concept of a liquidated damage.

In responses from the second consultation, four respondents supported the inclusion of the in-house cost. Two noted that the consequences of poor data quality are passed on through the Change of Supplier process and this should be reflected in the GPoL although direct cause and effect cannot be proven, the assumption that a poor performer passes on more bad data than a good one is not unreasonable. One of these considered that there may be an issue with the accuracy of this measure given the variances in types; costs and time taken in resolving problems.

Three respondents did not support the inclusion of the in-house cost incurred by Suppliers for correcting bad data in the GPoL methodology. One respondent questioned whether the cost should be factored in because Suppliers were already being 'encouraged' to address poor data issues through various ELEXON initiatives and because it doubted that the proposed approach would result in the right Parties being compensated. Another respondent opposed the inclusion because it questioned the proposition that a Supplier should be able to recover the cost of meeting a Code obligation (i.e. correction of bad data). Another respondent accepted that there are data quality transfer issues within the industry but did not believe this can be calculated to a level of accuracy required to meet the GPoL definition. The ability of a Supplier to be able to fix data problems (and the time it takes) would vary across the industry and would be impacted by things such as their relationship with their Data Collectors, how they utilise different systems and the processes they use.

The respondents' views are summarised in the Modification Report for Modification Proposal P157, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 11 December 2004 and considered Modification Proposal, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should approve the Alternative Modification and that, if approved, the Alternative Modification should be implemented on 1 December 2005 if an Authority decision is received on or before 3 March 2005, or 1 March 2006 if the Authority decision is received after 3 March 2005 but on or before 23 June 2005 and an Implementation Date for the Proposed Modification of 1 December 2005 if an Authority decision is received on or before 3 June 2005, or 1 March 2006 if the Authority decision is received after 3 June 2005 but on or before 23 September 2005.

Ofgem's view

Having considered the Modification Report and the Panel's recommendation, Ofgem considers, having regard to the Applicable BSC Objectives and its statutory duties, that neither the proposed or alternative Modification P157 currently provide sufficiently clear justification for some of the key variables which constitute the compensation payment. Accordingly, Ofgem considers neither solution can be adjudged capable of better facilitating the achievement of the Applicable BSC Objectives.

Charges

Ofgem notes the methodology used to calculate the revised level of charges incorporated into both the proposed and alternative proposals. As noted in Ofgem's Provisional Thinking, this methodology would have the effect of a significant reduction in NHH charges applied to Serial SP08a and an increase in HH charges applied to Serials SP08b and SP08c.

In responses to the second consultation, some respondents noted that the consequences of poor data quality are passed on through the Change of Supplier process and that this should be reflected in the GPoL. They also commented that the ability of a Supplier to be able to fix data problems (and the time it takes) would vary across the industry and would be impacted by things such as their relationship with their Data Collectors, how they utilise different systems and the processes they use.

The Modification Group considered two approaches, a 'top down' and 'bottom up' approach to assessing the supplier costs. A key variable that is used in the calculation using the methodology is the assumption made for the average time taken for each meter data problem to be 'fixed'. For the 'bottom up' approach, one supplier suggested that 15 minutes would represent a good average, whereas another suggested 12.5 minutes. With data provided by one respondent both 'top down' and 'bottom up' approaches produce a value of £0.09p per MWh

This analysis of the time taken to resolve individual data errors contributes to the eventual value of GPoL. Ofgem is concerned that although considerable work was undertaken by the Group, only two suppliers submitted values to the methodology used in the calculation of GPoL. Although the two suppliers broadly agreed in their assessment of the resources tied up in correcting data, the costs could be expected to vary considerably between different suppliers depending upon a number of factors including the scale of operations, experience of staff and degree of automation. Additionally, although the methodology is specified in the Assessment Report, the parameters used in the final calculation are not robustly defined. Were there to be a challenge to the GPoL value, or to support future reviews to update the GPoL value, clear definitions of the parameters would be essential. Indeed, where parties have dissented from the conclusions of the Group as to the value of GPoL, it is the assessment of supplier costs rather than the costs associated with the value of smeared energy that have proved to be controversial. Ofgem would need to be satisfied that the figures used to calculate the GPoL value were auditable and properly specified. This will require further consideration by the Group before Ofgem can be assured that the approach is sufficiently robust.

Redistribution

Both the original Proposal and the Alternative have been exhaustively modelled to establish the overall effects of various performance scenarios. Effects on different sizes of supplier in GSPGs have been considered as well as different mixes of NHH and HH customers.

It is Ofgem's view that the revised redistribution mechanism included in the Alternative Proposal would not better facilitate the relevant objectives of the Code. In particular, it is concerned that the redistribution mechanism proposed by the Alternative Modification is not consistent with the principle of supplier charges. Ofgem's view is that Parties should be compensated on the basis the loss they have incurred. For example, where a HH supplier fails to meet the required performance standard under SP08b or SP08c it will cause a greater chance of inaccuracy in allocated volumes in the NHH market. It will therefore pay a charge that is designed to compensate NHH suppliers, by way of the redistribution mechanism, for the additional smeared costs they may incur through GSP Group Correction Factor. Under the Alternative Proposal's redistribution mechanism, a NHH supplier will only be entitled to compensation for financial loss caused by the poorly performing HH supplier if they themselves are one of the better performers against SP08a – a separate and unrelated performance measure. If they are not, the charge and redistribution in this case would not reflect the loss that the NHH supplier has incurred.

In addition, Ofgem considers that the redistribution mechanism of the Alternative Proposal could result in greater volatility and reduced transparency in terms of a supplier's likely net position following charges and redistribution.

Ofgem notes that the revised distribution mechanism was designed to provide an incentive on Parties to improve performance and reach the required standards. However, Ofgem agrees with the view represented in the Modification Report that this attempt to create a strong incentive represents a move away from the principle of Supplier Charges being a compensation mechanism designed to reflect the genuine pre-estimate of the loss incurred by other Parties. Where they no longer reflect or compensate for this loss, their status as non-penal liquidated damages could be subject to challenge.

Caps

Ofgem has previously expressed its concerns over capping liability for charges under the Proposal. Ofgem's concerns arise for a number of reasons:-

1. Caps limit the charge and therefore may limit the compensation to a level below the GPoL. They benefit the net payers and poor performers to the detriment of the recipients of compensation;
2. Caps in the present arrangements cover a basket of serials. This approach introduces complexity in calculation, making the incentives less transparent and the system and management costs more expensive;
3. Caps dull the incentive to perform to an appropriate standard, due to the risk of failure being less severe;
4. Development costs of central and Parties' systems to handle caps may be wasted if they are rarely or never invoked.

Nevertheless, the introduction of caps could benefit competition, given the broad brush nature of Supplier Charges, if for example a particular class of Party – perhaps smaller Parties – were exposed to disproportionately high charges arising from a relatively low number of problem meters against a high volume of energy.

During the assessment of P157 a number of views were expressed in relation to capping the level of charges. Views were put forward to the effect that there had not been enough analysis of the detailed behaviour of the arrangements to be comfortable with the removal of caps and that the charges were imprecise and therefore needed caps. A number of respondents suggested during the assessment of P157 that caps should be set to cover exceptional circumstances.

Ofgem notes the analysis undertaken to devise an appropriate capping mechanism. It maintains its view that compensation payments may not cover the loss incurred by Parties if the charges were capped. It considers that, ideally, a damages compensation mechanism should not include caps. However, Ofgem notes the concerns of the Group and the consultation respondents regarding the removal of caps. While it does not believe that supplier charges can result in an unlimited liability without caps, it acknowledges that the calculation of the GPoL can only be an estimate and that some suppliers, particularly smaller suppliers, have particular concerns over their potential liability. Ofgem notes that the level of the cap proposed by both the Proposed and Alternative modification are set so that they stop significant liability in exceptional circumstances rather than limiting liability under normal circumstances.

Regarding serials charged on a per-day basis, it is Ofgem's view that suspending the application of such charges after a period which is determined by the Group to represent the time after which the payments no longer fall within the definition of a GPoL is likely to be appropriate. Ofgem does not see this situation as capping, but accepting that there comes a point where the damage to other parties is no longer occurring and compensation is no longer appropriate.

The Authority's decision

In summary, Ofgem is not able to approve either the Proposal or the Alternative in the absence of clear definition of the underlying assumptions behind key variables, in particular, the 15 minutes assumption for the average time to fix a metering system data problem. Ofgem is not sufficiently confident that either the Proposal or the Alternative would better facilitate the relevant objectives, for the detailed reasons above, as the compensation levels relating to the costs of poor data received from competitors have not been robustly determined. Nevertheless, were Parties able to demonstrate justification for the key variables in a new modification proposal, Ofgem would give that proposal due consideration.

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

Yours sincerely,

Nick Simpson
Director, Modifications
Signed on behalf of the Authority and authorised for that purpose by the Authority