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Dear Nicholas,

Ofgem's provisional thinking in relation to Modification Proposal P115, "Disapplication of Supplier Charges under certain circumstances"

These comments are provided in response to the Balancing and Settlement Code Panel's (the "Panel") request, under BSC F2.6.10 (b), for the Authority's¹ provisional thinking 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. Whilst the Authority has received an interim report from the Panel prepared in accordance with BSC F2.6.10 (a), the views expressed in this letter are without prejudice to the Authority's considerations after receipt of a Final Modification Report on this Modification Proposal.

This letter explains the background to the Modification Proposal and sets out the Authority's reasons for its provisional thinking.

Background to the Proposal

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.

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

Where a Supplier hub is not performing to the required Standard, that Supplier is liable to pay Supplier Charges (SCs). SCs are not meant to be punitive. Instead, the BSC² 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 submitted Modification Proposal P115 'Disapplication of Supplier Charges Under Certain Circumstances' ("P115") on 24 December 2002.

The Modification Proposal

P115 proposes 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. P115 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 Code.

The Proposer believes that in such circumstances, 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 due to their own failures.

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 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 has therefore suggested that the Authority rejects the Modification Proposal, but that work on the topic should continue under the expertise of the Supplier Volume Allocation Group. Additionally, it considers that the current provisions within the Code relating to Supplier Force Majeure may be applicable to the issue, but no current mechanism exists for processing such claims.

² Annex S-1, para 1.3.1

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, 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 challenged³, 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.

Ofgem’s provisional thinking

Ofgem considers that Supplier Charges fulfil two distinct roles.

First, the Balancing and Settlements Code (‘BSC’) defines Supplier Charges 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” (Annex S-1 paragraph 1.3.1). In addition, Ofgem believes that Supplier Charges provide a valuable 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 compromised by issues beyond the Supplier’s direct control. The Group identified a number of such issues, including known industry deficiencies and problems caused by the underperformance of other market participants, for example a previous Supplier where a customer has switched Supplier. The Group looked into whether any Supplier Charges levied in these circumstances should be disapplied.

It is Ofgem’s provisional thinking that the disapplication of Supplier Charges risks diminishing their function as defined in the BSC as a genuine pre-estimate of loss. If a proportion of Supplier Charges are disapplied, losses incurred by other Parties due to a Supplier’s underperformance will not be accounted for or reimbursed.

A process to disapply Supplier Charges could also, in Ofgem’s provisional view, erode the effectiveness of the incentives to attempt to resolve underlying issues that cause underperformance. Ofgem notes the difficulties experienced by the Group in

³ For reasons other than challenging the source of the data used in the calculations, in accordance with S-1 4.1.22.

identifying a viable mechanism for disapplying Supplier Charges. Ofgem considers that, were Supplier Charges to be disappplied, the process should be simple, transparent and equitable.

With reference to the first specific question raised, many of the performance standards recently reviewed as part of Modification Proposal P99 already accommodate for a degree of error by being set at less than 100%. Ofgem believes 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. Where this allowable level of error is thought to be inappropriate, change processes and mechanisms are in place to enable all Suppliers to propose to modify them. However, should the performance standards be lowered, this could have a detrimental effect on the quality of data entering settlement.

Were a Supplier to be entitled to claim force majeure for underperformance, the process for assessing the validity of such a claim, and the extent to which charges should be disappplied, should be transparent and equitable. The processing of claims of force majeure on these grounds will require clearly defined rules and guidelines that may be costly and difficult to handle effectively.

In response to the second question asked, it is Ofgem's provisional thinking that the process suggested during the Assessment Phase of P115 for disapplying charges arising from poor performance from a previous Supplier would be difficult to implement effectively without a clear and equitable mechanism for establishing responsibility for any error. Where error results in financial loss suffered by another Party, it would need to be considered whether the Supplier responsible for the error, if this can be clearly identified, should be liable to pay the Supplier Charges. If the financial cost of the error were not recovered, any loss suffered by other Suppliers will not be reimbursed. Again, such error can be considered to be recognised already through the concept of having performance targets that are not set at 100%. Currently the Supplier has the responsibility for ensuring the accuracy of data relating to its customer portfolio and is therefore liable for charges where there are inaccuracies.

The third question asks for Ofgem's views on the appropriateness of allowing Suppliers to challenge the level of Supplier Charges paid after such charges have been received. Under certain circumstances, for example where a defect in the mechanism for calculating the charges emerges, it seems sensible for a Supplier to be able to challenge the amount of charges paid retrospectively. However, it is not clear that Supplier Charges should be similarly retrospectively disappplied should a Supplier challenge them on other grounds. Suppliers should be fully aware of their liability for payment of Supplier Charges and this liability should be either under their control, within the allowable error included in the standards or potentially subject to Supplier Force Majeure.

Finally, we note the impact of caps in diminishing the incentives and the status of Supplier Charges as a genuine pre-estimate of loss (also defined in Annex S-1). It is

Ofgem's provisional thinking that the level of error that would result in a Supplier exceeding their 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 looks forward to the results of this analysis.

Ofgem's views expressed in this letter are without prejudice to the Authority's consideration after the receipt of Final Modification Report on Modification Proposal P115.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'A. N. Simpson', written over a horizontal line.

Nick Simpson

Director of Industry Code Development

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