

Meeting name VASMG - Issue 6 (4)

Date of meeting 16 October 2003

Paper Title COMMENTS ON IDEAS

Purpose of Paper For Information

Synopsis This paper incorporates all the comments received from VASMG members on the three ideas presented at the third meeting of the VASMG (Issue 6).

1. INTRODUCTION

1.1 At the third meeting of the VASMG three ideas based on corrective techniques were presented to the group. The three ideas were based on:

- Reallocation of GSP Group Correction Factor (GSPGCF)
- New Supplier Charges
- Naming

1.2 The VASMG have passed comments back to ELEXON, which are summarised below. A full list of comments received are included as Appendix A.

2. GSPGCF

- 2.1 Respondents expressed some interest in the principle of this idea. One respondent suggested a preference for illustrative example 1.
- 2.2 Most respondents agreed that a significant scheme of work would be required to see whether this idea could be realistically applied.
- 2.3 One respondent felt this idea failed the Predictability and Immediacy principles of a corrective technique that the VASMG had agreed. The respondent further felt that Suppliers already expose themselves to an unknown risk with the current GSPGCF.
- 2.4 A suggestion was made that an alternative would be not to allow Suppliers to correct erroneously large EAC/AAs and ensure that any EACs were larger than the default ones when used at RF.

3. NEW SUPPLIER CHARGES

- 3.1 The majority of respondents had difficulty with this idea as presented, especially with the use of SCs to fund the PAF in some way.
- 3.2 The following issues were raised
 - paying for PAF would indicate that the PAF costs become a 'Cap'
 - what would happen if all participants became compliant
 - any SCs seems to be moving pots of money around and are not an incentive
 - still uncertainty related to SCs due to any collection/redistribution
- 3.3 One respondent felt that any SCs should not be returned to offending Suppliers and should be returned to those Suppliers impacted as compensation for loss.

4. NAMING

- 4.1 Some respondents felt this idea could work as an effective technique others did not.
- 4.2 One respondent felt that the previous industry resistance to peer public comparison was an indication that the idea was a potent corrective technique. However, another response suggested that the impact was only a perceived threat and may prove less effective in practice.
- 4.3 The favoured option for naming seemed to be naming by exception. Respondents made suggestions on the idea, such as using a threshold or other trigger level for naming by exception.
- 4.4 One respondent felt that monthly naming would have greater potency than naming quarterly as the paper suggested. The respondent further expressed a desire that the technique could be applied to a number of obligations, as appropriate.
- 4.5 Another respondent felt that the data used may prove difficult to validate. Whilst one suggested that Suppliers have a self interest in correcting data as it may impact their ability to bill.

5. NEXT STEPS

- 5.1 The Panel asked that a report be sent back from the VASMG on their deliberations of Issue 6. The VAMSG will need to think about whether the current SCs are an effective corrective technique and if not what should be done. The VASMG have considered three ideas related to alternative corrective techniques which may be put forward as Modification Proposal, should any Party wish to raise one. This would allow ELEXON to carry out further work on any idea under the vires of the Modification Process.

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List of enclosures

Appendix A - Full list of comments on ideas presented at VASMG Issue 6 (3)

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GSP Group Correction factor approaches:

Comments 1.

I am very supportive of furthering the work on dissecting the GCF and identifying the effects of estimates, even if this is done solely to gauge the magnitude of the error (although I appreciate that this is extremely difficult since the GCF by definition contains everything that cannot be disaggregated.) Nonetheless, making a charge under settlement on a fair "polluter pays basis" fits better than the current system of arbitrarily defined fines. Dare I say that a GCF based approach fits the overall requirement of "fairness"?

Of the two approaches outlined in the paper, I favour the first (i.e. EACs attracting a greater share of correction energy than NHH based on AAs) on the basis of simplicity.

I do not understand the question of what would happen when GCF is less than or equal to 1. Surely it can be positive or negative. If estimates cause any imbalance the effect on other parties is actually the difference between the estimate and actual volumes multiplied by the difference between imbalance prices and market prices. An initial project should be initiated to come up with an estimate of this. Now probably is the time for a systematic study of the accuracy of EACs in comparison with AAs.

RE: Addendum to GCF

1.9 Total losses may be zero but if you are using absolute values for the total, the component parts (i.e. the deltas) should be treated the same.

1.12 As worded this is not strictly speaking a step but it is important to have a third delta to take away from the total and that is an estimate of the profile error, as this is not due to the number of estimates.

Are we excluding half hourly from all of this? If not, half hourly modelling needs to be done separately.

Illustrative example 2: I like this less. It is too simplistic i.e. it assumes other errors are constant which they clearly are not.

Comments 2.

A more radical solution would be to simply say there can be no corrections to data after the RF Run. If you have erroneously large EACs / AA, hard luck you should have sorted it out before. The effect of this is that you buy more energy than your customers really took and your competitors who do not have such errors will have bought less (via the GCF). The latter is slightly unfortunate as it means they will lose the difference between Contract Price and System Sell Price for the difference between what they actually used and what they are finally allocated. However they are still better off than anyone with erroneous EACs / AA who have either bought more energy under contract than their customers actually use or they have bought the extra quantity at SBP (which is on average higher than the Contract price).

In order to counter the incentive to under-estimate at RF we simply have an extra rule which says that any EAC must be greater than or equal to the Default EAC value for the H-PC-SSC combination.

It's very clear, much cheaper than doing DF runs and the financial incentive is in the right place and there are no Performance Assurance add-ons.

Comments 3.

In my opinion, this approach has significant features that would make it very attractive, particularly that incentives would be part and parcel of the trading arrangements. However, it also faces significant challenges in order to determine a fair and appropriate approach that will account for all the errors in the settlement process and produce appropriate incentives when the GSPGCF is less than unity, or during negative SSP and the incentive mechanism also needs to apply to HH energy as well.

In paragraphs 2.9 and 2.10, I disagree with the underlying implications being suggested by ELEXON. An AA is an accurate representation (ignoring the profiling anomaly which is corrected through the settlement process) of the annualised consumption between two points in time based on actual meter readings. An EAC is not based on consumption over a period, but uses historical data to forecast consumption. An EAC is therefore, by definition, less accurate than an AA. I don't believe that the age of an EAC is necessarily any indication as to its accuracy. But there is one point that hasn't been mentioned; that AAs and EACs are only "accurate" when applied over a large population of MPANs. At RF, EACs are supposed to represent 3% of the energy settled, and therefore they will be inaccurate due to representing a small number of MPANs.

Comments 4.

Interesting, but I am not sure this idea will result in an acceptable workable solution in practice. Loading the impact of GCF onto estimated energy (or the benefit onto actual) could have some undesirable effects in terms of Imbalances (especially where SSP is negative!), so I suspect that any mechanism would have to be horrendously complicated. It should also be noted that a significant part of GCF is due to inherent Profile error (i.e. Profiles not fully representing the vagaries of customer demand patterns). Proper analysis might also produce some interesting conclusions about the relative value of AAs (NHH) and 'estimated' HH data. Could it be that we require different Consumption Component Classes for different estimation techniques? If volumes are to be weighted, we also need to be very careful of the effect on variability between Reconciliation runs and hence on credit risk.

Comments 5.

I am a little uncomfortable with the idea of using correction factors. They are purely a balancing item to ensure that settlement always finds an answer and yes Suppliers do have to work with them at present. However, they are an unknown risk that the Supplier has to accommodate. A Supplier's BSC risk - his imbalance position, is not accurately known ahead of time because he does not control the demand of his customers. On top of that he faces an unknown +/- of the GCF. Multiply this by 14 (some of which may cancel out) and the range of outcomes becomes significant. Adding to this risk is not inconsequential (this could also be an argument to use this method) as it increases the need to be long contractually.

EACs: Making the NHH market 'settleable' in a half hourly market can only be done by estimates and allocation. Accuracy is a spurious concept here; fairness is the correct measure of quality. EACs are therefore not only legitimate, but essential for interim settlement. We have an RF at 14 months to reasonably allow for all meters to be read. Therefore penalising EAC use should only occur at an increasing rate in later runs (R3 and RF).

I do not like the idea of increasing the swings in cash flows between settlement runs - especially in the early runs. I am not sure that Suppliers would be able to react correctly (i.e. reduce EACs) to such market signals. Whilst I agree with the principled approach of the GCF paper, I do not believe it would work in practice. I also think it fails the predictability and immediacy tests.

Supplier Charges:

Comments 1.

As has previously been stated, the current arrangements for Supplier Charges were an agreed package under the Pool. There are many questionable elements in this package and it would be inappropriate simply to remove caps without revisiting other elements of the package such as £1.47 and the 90/10 transfer from HH to NHH. Analysis needs to be done on the different effects HH and NHH estimates have and this should be reflected in any Supplier Charges approach.

Unfortunately, I see little that makes the calculation of the ultimate bill being much more predictable since the redistribution is not calculable at the point of seeing the estimated volumes. This could be very dangerous for small Suppliers and hence bad for competition.

Also, I do not understand the concept of redirecting funds to pay for PAF. Up to this cost, monies would be shared on a market share basis and any surplus.....on a market share basis? The PAF cost seems more relevant as a cap, but again, what to do with monies in excess of this?

Comments 3.

I'm not convinced that this approach is worthwhile pursuing. The ELEXON proposal would see Supplier Charges (SCs) being used partly to fund PAF relating activities (Audit, Technical Assurance, PAB, educational exercises, error and failure resolution activities, etc). However, it is not clear how this would be managed if the overall level of SCs levied exceeded PAF costs. In this case, it would be necessary to implement some form of redistribution of the excess (ELEXON are not allowed to make a profit) and we're back with the problems that Suppliers have no clarity over how much SCs they are going to be liable for, and how much of a reduction would result from a performance improvement. In other words, it loses its appeal as an incentive if Suppliers cannot understand their liabilities.

There's also the problem in the long run that how will PAF costs be funded if all Suppliers become performant? However unlikely this is, the BSC arrangements do need to accommodate this possibility.

I'm also not convinced that this will achieve anything other than move money from one pot into another. Given that SCs are currently levied on the basis of a chargeable MWh figure, it would seem appropriate to assume that Suppliers with a larger share of the market pick up the highest level of SCs. They will also attract the highest level of BSCCo charges and so this proposal will simply reallocate charges without providing any additional incentive.

The suggestion to proceed without a Supplier cap needs to be given careful consideration. As an industry, are we happy that a Suppliers liability to SCs is potentially unlimited? From an expert group perspective, I'm nervous about this but recognise that the current Supplier cap complexity is one of the reasons why SCs don't work.

Comments 4.

This introduces certain useful elements such as an 'appeal' mechanism, but I am not sure whether 'funding the Performance Assurance Framework' is the objective we want - I would have thought that incremental impact on PAF costs (a reasonable pre-estimate of) would be more appropriate.

Comments 5.

If SCs are supposed to be LDs I understand they will have to be indexed to RPI or similar. How SC funds are dealt with requires some modelling; I remain with the principle that a party's SCs should not be recycled to that party. I'm not sure whether the SC fund should just offset the total ELEXON bill or a direct allocation according to funding shares is appropriate. We should approach the allocation on the basis of compensation to those who have suffered the consequential loss. Clearly, if the SC fund is based on the costs of PAF then those not involved with PAF should neither benefit nor be adversely affected.

Naming:

Comments 1.

Peer Comparison reports are very difficult to validate, even for the simplest of portfolios, hence the lack of challenge there has been thus far. Data aggregators sometimes wrongly submit estimated data, but Supplier Charges are not re-run to correct this. It is important that public naming is only used for Suppliers who consistently fail to meet the performance standards, since small suppliers have very variable statistics and the public naming due to this would not be in the interests of competition. I would define consistent as three months running. Appeal to PAB and an element of discretion are essential. Of the two options I definitely prefer naming by exception, but I'm not a big fan of this as an approach; it does nothing to improve settlements per se; ultimately, the market determines how important these issues are because customers who are fed up of receiving bills based on estimates will change supplier.

Comments 3.

As a member of the expert group tasked with implementing performance incentivising techniques, naming (either peer comparison whereby performance is ranked alongside other Suppliers / Agents, or exception reporting whereby non-performance Suppliers / Agents are explicitly named) seems a powerful technique. From previous industry consultation, it is clear that the majority of Parties do not favour this approach, which is surely an indication of the level of "fear" that this approach engenders. From this, I would infer that performance naming has the potential to provide considerable incentives for Parties to improve performance and it should therefore be progressed by VASMG. However, it should be noted that there may be considerable opposition to any modification proposal raised to give effect to these measures, and VASMG will need to bear this in mind when formulating the counter position.

Specifically, on the proposals contained within the report:

- 1) I agree that restricting performance comparison (PC) to Supplier Serials only is appropriate. I'm not sure that we only want to apply SCs at RF for HH energy (why not SF and R1 for Measurement Class C MPANs as at present?);
- 2) I'm concerned that the PC reports will only be published quarterly. This means that they have the potential to be up to 3 months out of date. ELEXON's rationale for this is that it gives Suppliers the opportunity to correct performance within the 3 month window, rather than within a 1 month window. My view is that if naming is going to provide a considerable incentive for Suppliers to improve their performance, they should be given the opportunity address performance problems and be represented accurately in the PC tables within a timescale quicker than 3 months. I don't see how this would be any less effective or fair than quarterly naming as ELEXON claim. If ELEXON are concerned that performance trends won't show through with monthly reporting, it would be possible to represent the information in different ways such that these could be seen. It may also be appropriate to report monthly on average performance values over a period longer than a month (eg. 3 months) to avoid reporting "blips" in a Supplier's performance.
- 3) I agree that an appeals process is required, and I suspect this is why ELEXON have suggested quarterly naming. If PC naming is to be carried out monthly, the appeals procedure needs to work within this monthly timetable. I'm not sure I like the suggestion that Suppliers would not be represented on the performance graphs if they had raised an appeal (even if there was a cost associated with this in the same way as with raising a dispute). How often would a poorly performing Supplier raise an appeal against his data in order to avoid being named on the graphs? By the time the appeal was concluded, it could be that the performance reporting had moved on to the next period and the Supplier could potential avoid ever being named by constantly raising appeals. I would rather see a time-limited appeals process, such as that used to dispute DPCs, that would result in every Supplier being represented on PC graphs at the same time. I also feel that 2 WD for Suppliers to query data is not long enough, and that maybe the 5 WD for PAA to respond could be adjusted, say, 4:3. I'm sure the paper is intended to imply that only the appealed SCs would be disapplied in the case of a Force Majeure claim, not the whole figure.
- 4) For naming by exception, the VASMG view was that this should be restricted to only significant settlement issues. At the moment, it is probably true to say that failure to meet Serial 1 is the most significant settlement issue and therefore that this should be singled out. However, it might be appropriate to build some flexibility into the arrangements such that a different Serial could highlight if this became more significant. Indeed, the rationale behind exception naming is that it should direct Suppliers towards performance improvements that will eventually lead to exception naming becoming obsolete. I don't think Serial 1 should be hard-coded into the BSC to the exclusion of the other Serials.
- 5) My preference would be to support the alternative suggestion for exception naming whereby a Supplier is identified when they fall below a certain trigger level, and only removed once they reach a higher trigger level. This removes all subjectivity associated with "consistent failure".

Comments 4.

In relation to a lot of performance measures (as with erroneous EAC/AA performance) non-performance also has an impact of processes such as billing, so the Supplier has a self interest in correcting this. Also, given that a lot of problems arise from the CoS process, there must be an issue about whether these reports will be comparing like with like w.r.t. new entrants/growing players and established/inactive 'incumbents'.

Comments 5.

We should avoid using the credit indebtedness naming as any precedent as that is not primarily a 'name and shame' action, instead it is to notify other trading parties that if they contract with the named party such that it increases that party's indebtedness, then those contract notifications will be rejected. So it is to protect the other trading parties and the future security of trading. May be I am from the too cynical school, but I do not believe naming and shaming has a real impact merely a perceived impact. So a Supplier is named, what penalty is that? What hurt is done to his business? Very few customers will change Supplier because they have been named on ELEXON's website as poor for settlement (NB. poor for settlement does not imply poor for customers). A perceived impact is only effective whilst the perception exists - it only takes one to shatter an illusion (and some may have to break it straight away). Naming can only be part of the PA package.

The mechanism for naming must be carefully thought through from the negative perspective i.e. what behaviour just avoids being named as opposed to achieving the 'good' status. On the proposal in the paper I would pitch at around 80% and leave it there to ensure I don't get named but avoid 'unnecessary' spend!

Comments 6.

We need to be careful about Naming (and Shaming/Congratulating) – any solution needs to be carefully considered. There are too many vagaries that impede the publishing of names. How accurate are the measures and do we know who is at fault? Suppliers are reliant on their agents for many of the performance measures and it is difficult for them to contractually get agents to adhere to all the measures as required and even more onerous to get them to accept SCs. In some cases, their accepting of SCs could bankrupt them! Some of the problems are also historical and may, in fact, lie elsewhere e.g. with the previous supplier and their agents. The quality of the measures may also be in doubt. Are they a true/factual account of what is really happening? ELEXON have mentioned that currently Parties are publicly named when they enter Level 1 and Level 2 Credit Default and see this as a good precedent. However, it should be noted that Credit Default is a well recognised financial measure / tool that is factually accurate and accepted by industry in general.

Additional General comments:

We agree that the present Supplier Charges framework through PARMS is poor and inadequate in places.

The new revised PARMS (P99) is an improvement on the previous framework but this will only be as good as the information provided by agents and we know how unreliable that can be. Suppliers should not be held responsible for this data or for agents' failures (see below for more on this)

With all the IT work going on around the energy industry the VASMG need to make sure that any changes to the current regime are minimal, properly targeted and least cost.

I believe a GCF approach needs fully exploring before naming or removing caps are even considered as these are just compounding the current flawed approach.

I suppose public naming could be used in conjunction with one of the other two proposals, although if Supplier Charges are not working and there is a cost associated, perhaps they should be scrapped. Should we have remove caps and introduce naming? I see no reason to be against the combination in principle, but as said, both approaches are seriously flawed.