

Meeting name BSC Panel

Date of meeting 13 November 2003

Paper Title ISSUE 6 - REPORT FROM THE VASMG

Purpose of Paper For Information

Synopsis This paper outlines the issues discussed and the ideas considered by the Volume Allocation Standing Modification Group (VASMG) in relation to Issue 6 'Appropriateness of the Current Supplier Charging Mechanism'.

1. INTRODUCTION

- 1.1 On 6 August 2003 energywatch asked that the appropriateness of the current supplier charging mechanism, as an incentive to improve data quality, be considered by a standing Modification Group. energywatch requested that the group explore whether an alternative incentive mechanism could be proposed that would be simpler and more transparent. The issue was logged as Issue 6 and passed to the Volume Allocation Standing Modification Group (VASMG).
- 1.2 The VASMG met four times to consider the issue and this paper provides a summary of the conclusions of the VASMG discussions.

2. CURRENT SUPPLIER CHARGES MECHANISM

- 2.1 The VASMG discussed the effectiveness of the current Supplier Charge (SC) mechanism. A number of issues were noted by the group and it was concluded that:
- current SCs are not easily understood by industry due to their complexity;
 - there is no certainty that the SCs applied for under-performance still represent a genuine pre-estimate of the current losses;
 - Suppliers are unable to accurately calculate what their SC liabilities are
 - funds collected from one Grid Supply Point (GSP) Group are redistributed to the other Suppliers who may be under performing in other GSP Groups (whilst it was noted that this is where the original loss may have been incurred it is clear that this dilutes the technique as an incentive);
 - there is no clear mechanism for disapplication, under appeal or for claims of 'force majeure';
 - there is little evidence to suggest that Suppliers' behaviour has changed as a result of the threat or application of SCs (however, one member noted that as SCs have not been applied continuously since NETA Go-Live and as such there is little evidence for the counter argument)
 - there are no formal rules for separating liabilities for SCs as a result of a mid month trade sale (and that only a workaround exists).
 - the SC capping process further serves to reduce the impact of SCs and reduces the effect of recovering any genuine pre-estimate of loss, by significantly reducing charges.
- 2.2 The VASMG discussed whether the current SC process could be improved by amending the current rules but were unable to conclude that any simple adjustments would significantly

improve the process. The example set out in paragraph 3 typifies the difficulty in seeking an effective, simple amendment.

- 2.3 At its final meeting the VASMG concluded that the current SCs were ineffective. This, coupled with the costs of processing, testing workarounds, report checking and query processing led the group to agree that they could be removed.
- 2.4 The group recognised, however, that other corrective techniques should be considered to replace the current SCs. The removal of the current SCs from the Performance Assurance Framework (PAF) would potentially lead to an imbalance in what was intended to be a complementary framework of techniques (a diagram showing the list of PAF techniques, showing where SCs sit within the PAF, is included as Appendix A). Any change would need to be given effect through use of the Modification Proposal process.

3. EXAMPLE OF AMENDING THE CURRENT MECHANISM - THE REMOVAL OF THE CAPS.

- 3.1 A simple idea would be to remove the caps which reduce the impact of the SCs. In theory this would seem to increase the incentive created by the current SCs by increasing the liabilities involved. In practice the VASMG recognised a number of issues.

Removing the caps would expose Suppliers to potentially unreasonable levels of charges

- 3.2 Removing the caps may impact smaller Suppliers more significantly than larger Suppliers. This is because not all SCs are volume weighted.
- 3.3 The most significant occurrences of SCs for non compliance with Serial 10 (late submission of PARMS data) tend to occur mainly when a newly qualified small Supplier enters the BSC arrangements. This may be because they have not agreed reporting requirements with their Agents or understood the process sufficiently.
- 3.4 The VASMG felt that caps should not be removed without further consideration of the Serials to which the SCs applied.

Do the SCs still represent a genuine pre-estimate of loss if the caps were removed?

- 3.5 The total SCs collected would certainly increase, based on current performance, but it is unclear whether this represents a better genuine pre-estimate of loss than the current SC levels.

Simply removing caps would not resolve the other issues referred to in 2.1

- 3.6 As funds would still be redistributed to those who had created the charges initially, albeit in different GSP Groups, Suppliers would still have no idea of their liabilities (as only one of the complex processes has been removed in this example) and there still remains no clear mechanism for disapplication

4. PRINCIPLES OF A CORRECTIVE TECHNIQUE

4.1 The VASMG concluded that a set of principles should be agreed that could be applied as a test to determine the effectiveness of any corrective techniques. It was the VASMG view that any corrective technique should satisfy a most of these principles.

4.2 The principles agreed by the VASMG were:

- **Simplicity:** The VASMG felt that simplicity was a desirable feature of a corrective technique. Simplicity should ensure that the technique is understood by all participants and all participants would be aware of the circumstance in which the technique would apply to them. However, the VASMG suggested that simplicity should not equate to crude. A corrective technique that met all the other principles but remained complex could be preferable to a simple technique that did not meet all the other principles.
- **Transparency and Clarity:** Most VASMG members considered it important that participants are able see how the PAF techniques were to be applied to them. All elements of the technique should be visible and it should be clear what is expected of participants and what the effects of the technique are. One member observed that, if the incentive were a financial one, then the inability to gauge the cost of failure may incentivise participants to act in accordance with their obligations.

The VASMG noted that the Authority's ability to 'financially incentivise' Parties (through the existing legislative framework) was effective because Parties do not know what the cost of their non compliance will be. The VASMG acknowledged that the BSCCo may not be able to apply a financial incentive of the same magnitude as the Authority as the BSC is bound to comply with general rules of contract law and by application of 'liquidated damages' as a genuine pre-estimate of loss.

- **Significant in Magnitude:** The VASMG agreed that there was little point in having incentives if they only had a negligible financial impact.
- **Progressive and Reflective of Performance:** The VASMG agreed that incentives should be explicitly linked to a clearly desired outcome. The further participants deviate from their obligations, the bigger the incentive should be to comply. One member suggested that there are some difficulties with the transfer of data at Change of Supplier (CoS) and, therefore, some participants may be penalised for inherited problems. The VASMG noted that issues associated with poor data quality were being addressed elsewhere, and also agreed that the effects of CoS were a business risk and individual Parties should take this into account as part of their Risk Management Plans when taking on new customers.
- **Reflective of Impact:** The VASMG noted that a failing participant with a significant market share would have a bigger impact on settlement than a smaller participant. The VASMG agreed that the ability to scale the technique was desirable, provided that it does not add too much complexity.
- **Immediacy:** The group agreed that incentives work best when the non-compliance is addressed quickly. Delayed processing may have the effect of lessening the impact.

4.3 The group agreed that the current Supplier Charges do not meet these principles.

5. CORRECTIVE TECHNIQUE IDEAS CONSIDERED BY THE VASMG

- 5.1 A number of ideas for alternative incentive mechanisms and corrective techniques were discussed by the VASMG. For example, one of the ideas was to make Party Agents signatories to the Balancing and Settlement Code so that obligations could be placed directly on Agents. This idea was discounted as it would require primary legislation and could not be explored further within this group.
- 5.2 The group agreed three main ideas for further consideration under Issue 6 which are outlined below. More detailed information on these options can be found in Attachment 2.

Idea 1 - New Supplier Charges:

- 5.3 The VASMG considered a new form of SCs. The components of which are:
- SCs to be based on the percentage of energy entering Settlement only, so Suppliers can easily ascertain their liabilities based on their own performance;
 - that no capping should be applied;
 - to use settlement data to allow for apportionment in the event of a trade sale and disapplication in the event of appeal/ 'force majeure' claim
 - to have a robust appeal mechanism and mechanism for dealing with 'force majeure' claims
 - to allow validation of the data by Supplier
 - to use funds collected to contribute to the cost of the PAF (via part of the costs of the BSC Co)
- 5.4 The group agreed that further consideration of the appropriate levels of SCs would be required for any new form of SCs.
- 5.5 The group was unconvinced that an alternative form of SCs had any merits. There remained concerns that the SCs should be a genuine pre-estimate of loss and this may yield SCs that are not sufficient to naturally encourage compliance. The group was also unconvinced that funds should be directed towards the cost of the PAF, especially if the costs of the PAF are reduced then the PAF cost effectively becomes a cap. Similarly the reduction of funds from the BSCCo is a form of redistribution of funds.

Idea 2 – Reallocation of Grid Supply Point (GSP) group correction energy based on estimates submitted into settlements:

- 5.6 The VASMG considered the idea of amending the current rules surrounding the application of GSP group correction energy. Two possible scenarios were considered. First, to apply a greater proportion of the group correction energy to Estimated Annual Consumptions (EACs) than to

Annualised Advances (AAs). The second scenario would see additional volumes being applied directly to EACs (as opposed to applying a Group Correction Factor).

- 5.7 The group showed interest, particularly for the first idea and noted that it created a financial incentive as an intrinsic part of the trading arrangements. The group were keen to see more detail but also recognised that further consideration of this issue would require significant work to be undertaken, including how this activity would apply to Half Hourly data and how it would be put into practice.
- 5.8 The group also noted that EACs are a legitimate means of settling data and essential to the Supplier Volume Allocation processes. Therefore, any application of group correction energy should avoid creating a perverse incentive to submit inaccurate AAs or Actuals. The group made some suggestions that the incentive could be applied at latter settlement runs.

Idea 3 – Naming

- 5.9 The VASMG considered two proposals relating to the use of Naming as a corrective technique. The first was to use simple peer comparison reported on a regular basis. The second idea was to use naming by exception.
- 5.10 The group noted a suggestion that peer comparison could be used on a quarterly basis, posted on the ELEXON website showing performance against the percentage energy Serials. The proposal included a data validation process and appeal process.
- 5.11 The group also noted that a process of naming by exception could be used, akin to the one used for naming when Parties fall into Level 1 or Level 2 Credit Default. Again, the use of the percentage energy Serials was proposed and the technique could be used as a result of participants being outside a certain threshold (e.g. 90% of the standard). The process includes a data validation and query process.
- 5.12 Of the two ideas the VASMG felt naming by exception was the more favourable. It was noted that the rules surrounding this technique would need to be clear, such that no participant is named in error. The group acknowledged that the resistance of industry previously to any form of naming suggests that the technique could be a powerful one. One member suggested that the threat of naming was probably more potent than the naming itself.

General comments

- 5.13 The group briefly considered whether these ideas could be taken forward as a package. It was recognised that naming could exist as a stand alone technique. Naming may be useful in moving a participant from a position, for example, 10% below a standard to within 5% of a standard but would not incentivise an errant participant who chooses to remain non compliant. Therefore the naming would need to be used in conjunction with techniques such as escalation. It was recognised that the naming technique could be used alongside either of the two financial incentives outlined above. However, it felt that it would not be appropriate to use the two financial incentive techniques together as this is effectively a double penalty.
- 5.14 At its final meeting the VASMG noted that the Authority seemed to have the ability to impose more effective financial incentives outwith the Code. The group had previously noted that any financial incentive within the BSC may be constrained by general contract law.

- 5.15 At the extreme end of the BSC Panel powers, any serious or persistent non compliance with the Code, can lead to notices of breach and default, resulting with the ultimate sanction of expulsion from the Code. Whilst this is a useful measure for persistent non compliance it was felt that a lesser but effective corrective technique was desirable to encourage compliance without having to resort to drastic measures.

6. NEXT STEPS

- 6.1 The ideas contained within this paper and its attachments have been given due consideration by the VASMG, however for any further detailed work to be carried out it would be more appropriate to undertake this under the auspices of a Modification Proposal. The group recognised that any Modification Proposal would need to better meet the combined Applicable BSC Objectives.
- 6.2 The details within this paper and its attachments provide enough information for Parties to consider the effectiveness of the current Supplier Charges mechanism and the potential for alternative corrective techniques, should they wish to raise a Modification Proposal.

7. RECOMMENDATION

- 7.1 The Panel is asked to **NOTE the discussions and findings of the VASMG.**

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List of enclosures

Appendix A – The PAF techniques

- Attachment 1 – energywatch letter relating to Supplier Charges
- Attachment 2a – Naming
- Attachment 2b - Hybrid Supplier Charges
- Attachment 2c - GSPGCF Incentives to submit actual data
- Attachment 2d - Comments on Ideas

APPENDIX A – The PAF techniques

