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National Grid Electricity Transmission plc,
BSC Signatories and Other Interested Parties

21 November 2005

Our Ref: MP No P182

Dear Colleague,

Modification of the Balancing and Settlement Code (“BSC”) - Decision and notice in relation to Modification Proposal P182: “Review and redefinition of the Non Half Hourly Settlement performance measures”

The Gas and Electricity Markets Authority (the “Authority”)¹ has considered the issues raised in the Modification Report² in respect of Modification Proposal P182, “Review and redefinition of the Non Half Hourly Settlement performance measures”.

The BSC Panel (the “Panel”) recommended to the Authority that neither the Proposed Modification nor the Alternative Modification should be made.

The Authority has considered the Modification Report and the Panel’s recommendation and the Applicable BSC Objectives³ in its assessment of Modification Proposal P182. The Authority has determined that neither the Proposed Modification nor the Alternative Modification would better facilitate the Applicable BSC Objectives.

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

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

² ELEXON document reference P182RR, Version No. 1.0, dated 12 August 2005

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; and
- d) promoting efficiency in the implementation and administration of the balancing and settlement arrangements

Background

Annex S-1 of the BSC sets out a number of performance measures (“Serials”) and associated levels of performance (“Standards”) that Suppliers are required to achieve. The Standard associated with one of these Serials, Serial SP08a, requires all Suppliers to ensure that at the Final Reconciliation Run (“RF”) at least 97% of all energy settled in respect of its non half hourly (“NHH”) metering systems is based on Annualised Advances (“AAs”). Failure to achieve this Standard will render the Supplier liable to pay charges in relation to its level of underperformance.

Issue 11 “Performance Targets and Monitoring” was raised on 3 September 2004 by Centrica, Powergen and Scottish Power to consider whether the 97% Standard under Serial SP08a was equitable and provided adequate accuracy of data entering Settlement. In addition, Issue 11 also considered whether any improvements were required in the way in which audit issues are rectified and whether there should be a differentiation between large and small Suppliers in how performance standards are applied and/or enforced.

The Volume Allocation Standing Modification Group (“the Group”) met to consider Issue 11 on 28 September 2004 and 19 November 2004. They noted that the methodology behind the 97% target is not well defined and, having considered analysis carried out under a previous modification relating to the accuracy of AAs and Estimated Annual Consumptions (EACs)⁴, determined that this performance measure may not be appropriate in order to deliver equitable and accurate settlement of NHH energy. They noted that the industry has been making efforts and incurring significant costs to achieve the 97% target but that an improvement in their performance would not necessarily result in a proportionate improvement in the accuracy of Settlement. The Group believed that this 97% target should be revised and that other issues, such as the effective resolution of material market issues, had a bearing on the equity and accuracy of Settlements but may not be being resolved in appropriate timescales.

In order to rectify this situation, Centrica, Powergen and Scottish Power submitted Modification Proposal P182, “Review and redefinition of the Non Half Hourly Settlement performance measures” on 29 November 2004.

The Modification Proposal

Modification Proposal P182 seeks to modify the BSC so as to revise the 97% performance Standard for Serial SP08a to 95.5%. This would require Suppliers to ensure that at RF at least 95.5% of all energy settled in respect of its NHH metering systems is based on AAs. The modification also sought to review the process for resolution of material market issues and to consider whether a performance measure based on the age of EACs, the accuracy of which was considered to decline over time, should be developed. The justification for the Modification Proposal was that it would better facilitate achievement of Applicable BSC Objectives C3 (3) (c) and (d).

The Modification Proposal, it was argued by the Proposers, would have the effect of reducing barriers to entry caused by the high level of costs required to achieve the 97% Standard when

⁴ Modification Proposal P157 “Replacement of current Supplier Charges rules”

this target does not have a documented rationale and when there is evidence to suggest that achievement of this Standard will not necessarily result in more accurate allocation of energy between Suppliers. It was considered that Modification Proposal P182 would also reduce the incidence of escalations to the Performance Assurance Board (PAB) through Parties failing to achieve the required Standard, thereby allowing the PAB to concentrate on poor performance and allowing a reduction in costs to ELEXON in enforcing stringent targets.

The Panel considered the Initial Written Assessment at its meeting of 9 December 2004 and agreed to submit Modification Proposal P182 to the Definition Procedure. The Group met three times during the Definition Procedure and issued a consultation to the industry on 1 February 2005. On 10 March 2005 a Definition Report was presented to the Panel, highlighting that the subject of material market issues had been removed from the Modification Proposal as it was deemed not to require a modification.

The Panel agreed that Modification Proposal P182 should proceed to the Assessment Procedure. The Group met a further five times and considered the proposed methodology for calculating a Standard, whether such a Standard should be different for certain Profile Classes and how a newly developed Standard would be benchmarked against current performance to ensure that performance did not deteriorate. The Group was also presented with analysis of the accuracy of EACs and how this changed over time. It gave consideration to whether a performance measure should be applied to EACs based on their age but decided that this area should be removed from the scope of Modification Proposal P182.

The Group issued a consultation to the industry on 16 May 2005. An extension to the Assessment Procedure was granted by the Panel on 9 June 2005 in order for the Group to consider implementation costs and to consult the industry on an Alternative Modification based on a Calendar Day implementation rather than a Settlement Day implementation. This would mean that the new Standard would be applied to Suppliers' performance in all the RF runs that occur after the Implementation Date rather than performance at RF in respect of Settlement Days after the Implementation Date. On consideration of the potentially high implementation costs, the Group decided not to propose that Serial SP08a should have different Standards based on Profile Class groupings.

The Assessment Report was presented to the Panel on 14 July 2005 which recommended that the Modification Proposal should proceed to the Report Phase with a Panel recommendation to reject both the Proposed and Alternative Modifications.

A draft Modification Report was issued for industry consultation on 20 July 2005.

Respondents' views

ELEXON published a draft Modification Report on 20 July 2005, which invited respondents' views by 3 August 2005. 15 responses were received representing 59 Parties and 2 non-Parties. In relation to the Alternative Modification, 8 responses (representing 27 Parties and 1 non-Party) expressed support for the Alternative Modification and 7 responses (representing 32 Parties and 1 non-Party) opposed the Alternative Modification. In relation to the Proposed Modification, 4 responses (representing 3 Parties and 1 non-Party) expressed support for the Proposed Modification, 11 responses (representing 56 Parties and 1 non-Party) opposed the Proposed

Modification and the remaining 2 responses (representing 2 non-Parties) provided a “no comment” response.

A minority of respondents disagreed with the Panel’s recommendation that the Proposed Modification should not be made. They considered that the costs to achieve the 97% Standard are high and divert effort away from meeting customers’ requirements for accurate and lower bills. Another respondent considered that the purpose of Modification Proposal P182 was not to improve data quality, noting that Serial SP08a is only one indicator of data quality. They considered that the Proposed Modification met the requirements that it set out to achieve. Another view was expressed that the Proposed Modification would set a performance Standard that is higher than the average industry performance and would therefore ensure that Suppliers continue to input the same level of resource in order to maintain current performance levels. Another respondent considered that the Proposed Modification would prevent Suppliers from being unduly penalised for the actions of its customers since it is they who determine the ability of Suppliers to access premises to secure meter readings.

The majority of respondents agreed with the Panel’s recommendation that the Proposed Modification should not be made. Some considered that the proposed reduction in the Standard could lead to a reduction in data quality. Views were expressed that the long term effects of this possible reduction have not been considered, such as their potential to impact on customer transfers. Other respondents believed that the 97% target should be retained in order to ensure that the quality of data entering Settlement improves. Another respondent agreed with the Panel’s recommendation on the grounds that the Proposed Modification reduces the performance Standard but does not put in place alternative measures to maintain and improve data quality. One respondent believed that the effects on distribution companies of a reduction in this performance Standard had not been sufficiently considered. Some respondents agreed with the Panel’s recommendation to reject the Proposed Modification on the grounds that they considered the Alternative Modification to be preferable.

In relation to the Alternative Modification, the majority of respondents disagreed with the Panel’s recommendation that the Alternative Modification should not be made, citing many of the same reasons as those expressed in disagreement with the Panel’s recommendation in relation to the Proposed Modification. Additionally, respondents considered that the Serial SP08a performance Standard has no scientific basis, that all Suppliers are still failing to achieve it and that it therefore has a credibility issue. The revised target, one respondent suggested, is based on data analysis and represents an improvement on what the industry currently achieves while providing an equitable and tolerably accurate target for performance against this Serial. Respondents also considered that the data analysis undertaken indicates that lowering the Standard will not be detrimental to data quality as the effect on the accuracy of consumption volumes with 95.5% of energy settled on AAs at RF is minimal compared to if 97% is settled on AAs. One respondent believed that Suppliers are spending increasing amounts of money in trying to achieve a target that has proven to be unachievable by the vast majority of them. They considered that this expenditure is therefore being wasted and this results in customers paying for Suppliers’ efforts to get meter readings from customers from whom it is difficult to obtain a reading.

A minority of respondents agreed with the Panel’s recommendation that the Alternative Modification should not be made. The arguments expressed to support this view were the same

as those expressed in support of the Panel's recommendation in relation to the Proposed Modification.

The respondents' views are summarised in the Modification Report for Modification Proposal P182, which also includes the complete text of all respondents' replies.

Panel's recommendation

The Panel met on 11 August 2005 and considered Modification Proposal P182, the draft Modification Report, the views of the Modification Group and the consultation responses received.

The Panel recommended that the Authority should reject both the Proposed Modification and the Alternative Modification. However, if approved, the Panel recommended that the Proposed Modification should be implemented on a Settlement-day basis on the first day of the first calendar month that commences at least 20 working days following an Authority decision. If the Alternative Modification were approved, the Panel recommended that the Alternative Modification be implemented in the same timescale as the Proposed Modification but on a calendar-day basis.

Ofgem's view

Having considered the Modification Report and the Panel's recommendation, Ofgem has decided not to direct a modification to the BSC based on either the Proposed Modification or the Alternative Modification. Notwithstanding this decision, Ofgem considers it important to highlight that the Panel failed to base its recommendations to the Authority on the Applicable BSC Objectives. Should Ofgem have been minded to make a direction, these failures may have precluded it from issuing such a direction. In the remainder of this letter Ofgem sets out its views in relation to the substance of the Modification Proposal, then goes on to highlight concerns on the process followed.

Serial SP08a requires Suppliers to settle 97% of NHH energy based on AAs at RF. Analysis reviewed under this Modification Proposal indicated that, as they submit more readings into the Settlement arrangements during the 14 month reconciliation process, the quantity of energy that Suppliers settle does not vary significantly compared to the increase in the proportion of that energy that is based on AAs. The Group considered this analysis and concluded that the accuracy of EACs, when netted across a Supplier's portfolio, is not significantly lower than the accuracy of AAs. It was also noted that both EACs and AAs are estimated values as they require the use of profiles and Line Loss Factors in order to derive them. AAs are however based on a given meter advance typically between two actual meter readings rather than an estimate of consumption since the previous meter reading. As such, AAs may be considered to provide greater certainty that volumes settled are accurate even if they are not themselves significantly more accurate values.

Ofgem considers that the Proposed Modification and the Alternative Modification may have negative effects on this certainty of settlement accuracy as well as the quality of industry data. These have the potential to have a negative impact on competition and thereby not better

facilitate Applicable BSC Objective (c). In Ofgem's view, insufficient evidence has been presented as to the benefits that the Proposed and Alternative Modifications would bring to competition in order to demonstrate that, on balance, any such negative effects are outweighed and that the Applicable BSC Objectives would be better facilitated.

Impact on the certainty of accuracy of Settlement

Ofgem notes the work undertaken by the Group to analyse the level of uncertainty of consumption of the current and suggested new Serial SP08a performance Standard. It considers that the relaxation of the 97% target to 95.5% is likely to result in Suppliers being required to spend less money to achieve their obligations. This may reduce some Supplier costs. However, Ofgem considers that these possible cost savings would come at the expense of a reduction in the certainty of the accuracy of Settlement volumes. While the reduction in certainty of accuracy appears from the analysis to be comparatively low, it does however still constitute a reduction.

In addition, the analysis that the accuracy of EACs is not significantly worse than that of AAs is based on a large volume. It is not clear whether the reduction in certainty of accuracy would be greater in respect of Suppliers with smaller portfolios. Ofgem notes the comments expressed by some of the Group members that the revised standard is above the current average performance level and that therefore there could be no reduction in performance if either the Proposed Modification or the Alternative Modification were made. Ofgem does not consider that this argument has been adequately substantiated. Ofgem considers that the proposed new Standard would constitute a material reduction in the level of certainty of accuracy that the Settlements arrangements are designed to achieve.

Ofgem notes the argument put forward by a consultation respondent that the costs of reaching the 97% target may dissuade new entrants and that therefore a reduction in the Standard would better facilitate Applicable BSC Objective (c). However, Ofgem has heard concerns from smaller suppliers that the certainty of accuracy of settlement volumes is crucial for them to be able to manage their cash-flows. As such, Ofgem has concerns that the Proposed and Alternative Modifications may create an additional risk for smaller suppliers and thereby negatively impact competition and facilitation of Applicable BSC Objective (c). In Ofgem's view, insufficient evidence has been presented to demonstrate that such potentially negative effects on competition are outweighed by potentially positive effects in order to determine whether, on balance, the Applicable BSC Objectives would be better facilitated. Further consideration of the analysis presented as to the costs and benefits of the Proposed and Alternative Modification is set out below.

Impact on data quality

Ofgem considers that a reduction in the performance Standard of Serial SP08a may lead to an increase in the number of data anomalies that the industry rules are designed to tolerate. AAs are produced by collecting actual meter readings, whether collected by Suppliers and their agents or received from customers, and processing those readings through the various systems and processes of the Settlement arrangements. A reduction in the Standard to 95.5% would therefore mean that, compared with the current position, the industry is prepared to tolerate a lower number of AAs. This means that the BSC rules would tolerate either fewer actual meter readings being obtained in order to generate AAs or a greater incidence of data anomalies that would

prevent meter readings from entering Settlement compared to the current design of the arrangements.

Ofgem considers that the incentives on Suppliers to acquire accurate meter readings for customer billing are likely to lie outside of the BSC performance Standards and that a reduction in those Standards is therefore unlikely to impact the number of actual meter readings obtained.

However, Ofgem does consider that the possible effects on data quality have not been sufficiently explored. Ofgem notes comments expressed by one respondent that data quality would not be reduced as a result of this modification. However, Ofgem considers that a distinction should be drawn between, on the one hand, the small reduction in certainty of accuracy that the analysis suggested is likely to result from a lower standard and, on the other, the effects of an increase in the number of data anomalies that are permitted by Serial SP08a. The latter was not given as much consideration. The Proposed and Alternative Modifications could have the effect of increasing the number of data problems that would be tolerated by the BSC rules. This view is reflected in a number of consultation responses from participants who believe that the long term effects of the modification on data quality have not been sufficiently considered. Some respondents noted that the reducing the Standard to 95.5% may lead to degradation in data quality. Degradation in data quality is likely to have a negative impact on competition as industry data problems and increased exception handling may frustrate processes of central importance to competition, in particular the change of supplier process. Suppliers are likely to face further costs than at present in resolving data problems, and PAB and ELEXON may need to devote more resources to addressing the consequences of these data anomalies. This may have a proportionally greater impact on new suppliers and a potential deterrent effect on new entrants to the market.

Again, Modification Proposal P182, in Ofgem's view, has not provided sufficient weight of evidence that the benefits of the cost savings that may be realised by market participants are sufficient to outweigh the potential costs from a reduction in data quality and accuracy that could be associated with a reduction in performance Standards. As such, Ofgem does not consider that a compelling case has been made that, on balance, the Applicable BSC Objectives would be better facilitated.

Analysis of costs and benefits

Consideration of any potentially detrimental effects of a Modification Proposal must be weighed up against the benefits that the Modification Proposal may bring in order to determine whether the Applicable BSC Objectives would be better facilitated. Ofgem does not consider that the analysis presented is sufficient to make such a determination.

Modification Proposal P182 was raised on the principle that Suppliers and their agents are experiencing significant costs in trying to achieve the SP08a Standard when, in doing so, they are not significantly increasing the accuracy of settled volumes. Ofgem has no visibility of the extent of these costs and the Group was not able to quantify them. Without information about these additional costs, Ofgem is not able to assess the materiality of the perceived defect or the benefit in efficiency that could result from such cost savings. Ofgem notes that one respondent believed that any reduction in costs has to be good for consumers but it considers that such reductions have to be considered in conjunction with any resulting reduction in the acceptable

level of accuracy of Settlement or the effective operation of, for example, the change of Supplier process.

Ofgem notes that respondents were asked in the second Assessment Procedure Consultation to comment on whether they considered that the resources and effort expended to achieve and maintain 97% are cost beneficial, taking into account the benefits that come from improved customer billing, more accurate forecasting, fewer exceptions and so on. While views of the industry were split on this subject, a number of respondents considered that the benefits of achieving the current performance measure outweigh the costs, pointing out that they had seen improvements in all areas of the 'meter-to-bank' process and in the quality of service they offer to their customers. Other respondents expressed similar views on the benefits that are provided by the current Standard in the Report Phase Consultation. In addition, Ofgem has not been presented with a full assessment as to whether the costs savings derived from the proposed move to a 95.5% Standard would improve competition. Indeed, as noted above, views have been expressed to Ofgem that a high level of certainty of accuracy and data quality are important to new entrant Suppliers in order for them to have certainty of cash-flows and the ability to transfer customers smoothly.

There is therefore, in Ofgem's view, no clear picture of the benefits that would be derived from Modification Proposal P182 that would counteract the potential negative impacts on the certainty of the accuracy of Settlement or the smooth operation of key industry processes. This lack of clarity is reflected in the contrasting views of the respondents.

In order for Ofgem to approve any modification to the BSC, it must be satisfied that the Applicable BSC Objectives would be better facilitated. In the case of Modification Proposal P182, the case for approval relates to better facilitation of Applicable BSC Objectives (c) and (d). Arguments have been put forward that the effect of the Proposed and Alternative Modifications would bring improvements to competition and in the efficiency of the administration of the balancing and settlement arrangements. However, these must be balanced against the potentially detrimental impacts that a reduction in certainty of the accuracy of settlement and data quality may have on competition in particular. Without a more thorough analysis of these possible effects, Ofgem cannot determine whether, on balance, the Proposed or Alternative Modifications would better facilitate the Applicable BSC Objectives.

Ofgem notes from the Modification Report and the original Modification Proposal that the stated criteria recommended by the proposers of Modification P182 against which the solution developed should be judged, include the creation of natural, self-policing incentives to settle more accurate energy volumes and an increase in the accuracy of customer billing.

While it does not constitute the basis for Ofgem's decision, it does note that neither the Proposed nor Alternative Modification would achieve these stated criteria. No evidence has been presented that either the Proposed or Alternative Modifications would create a natural and self-policing incentive on Suppliers to settle more accurate energy volumes. Ofgem also does not consider that the accuracy of customer bills would be increased by the Proposed or Alternative Modifications. As noted above, Ofgem does not consider that the 97% Standard is the driver for accurate customer billing. Nevertheless, a Standard of 95.5% would not, in Ofgem's view, improve the ability of a Supplier to bill accurately compared to a Standard of 97%. Ofgem considers that the reduction of the Standard may lead to a reduction in the level of

data quality or the collection of actual meter readings being tolerated, neither of which would lead to more accurate bills being issued to customers.

Ofgem notes the concerns expressed by one respondent that Serial SP08a performance has been wrongly targeted as the root cause of audit, data quality and customer billing. Ofgem considers that the 97% performance standard may provide an overview of the effective operation of Settlement processes but does not consider that it is necessarily the best way of measuring and managing performance issues. However, in order for Ofgem to approve a change to any performance Standard in the BSC, there must be sufficient weight of evidence to demonstrate that the achievement of an Applicable BSC Objective would be better facilitated.

Ofgem notes that work is underway to review the BSC Performance Assurance Framework and the performance measures built into the BSC. Ofgem is supportive of this review and encourages those involved to give full consideration to the issues highlighted in this modification.

The requirement for Panel to base its recommendation on the Applicable BSC Objectives

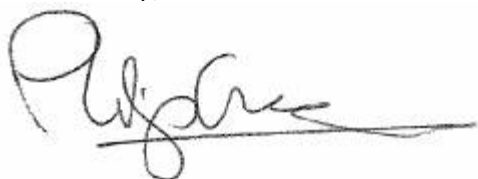
Ofgem notes that the Panel did not base its recommendation on the Applicable BSC Objectives, citing a perceived detrimental effect on customers and “the wrong message” being sent to industry amongst the reasons for recommending rejection. There is no explicit or implicit linkage between either customer (or consumer) issues or “wrong messages” and any of the objectives.

When a Modification Report is submitted to the Authority, the Authority must assess whether the Proposed Modification (and Alternative Modification, if relevant) would, compared to the existing provisions of the BSC, better facilitate achievement of the Applicable BSC Objective(s). Only then may the Authority direct a modification to the BSC.

When making its recommendations to the Authority in the Modification Report, the Panel must assess the extent to which the Proposed Modification (and Alternative Modification, if relevant) would better facilitate achieving the Applicable BSC Objectives. When carrying out that assessment, on which its recommendation is based, extraneous matters must not be taken into account. Should such matters form the basis of a recommendation, the Authority may not have the power to direct a modification and/or consider it necessary to refer the Modification Report back to the Panel for proper assessment. Ofgem highlights the continued necessity for the Panel to link all of its recommendations clearly to the Applicable BSC Objectives.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Philip Davies', with a long horizontal flourish extending to the right.

Philip Davies

Director, Consumer Markets

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