

## CAP 127 – 3<sup>rd</sup> Working Group

Wednesday 15<sup>th</sup> November 2006

**Present:** Hedd Roberts (HR) National Grid Chair  
Beverley Viney (BV) National Grid Technical Secretary

**Members:** Jenny Boothe (JB) Ofgem  
Toby Thornton (TT) National Grid  
Wayne Mullins (WM) National Grid  
Bec Thornton (BT) National Grid  
Mark De Souza (MD) npower  
Lee Selway (LS) EdF  
Ben Sheehy (BS) E.ON  
Dave Wilkerson (DW) Centrica

**Apologies:** Andrew Colley (AC) Scottish & Southern  
Paul Murphy (PM) National Grid  
Carl Wilkes (CW) npower  
Keith Munday (KM) Bizz Energy

### Introduction

HR outlined the timescales for this Working Group. The CUSC Panel has given the Working Group a 3 month timescale, therefore the Working Group Report needs to be issued to the Working Group members for comment no later than the 28 November in order to be issued with the CUSC Papers on 7 December.

### CAP 127

The elements feeding into the base VAR profile were briefly summarised by WM, and any outstanding actions covered:

- The group had previously agreed that assuming average weather conditions was the most sensible approach;
- The group had previously agreed that Final Reconciliation amounts of 1% of annual NHH liability and 0% of annual HH liability should be taken;
- The group had previously agreed that the average set of triad dates should be used. In response to an action from the previous meeting, WM stated that National Grid had considered removing unlikely triad dates from the data set used to calculate average set of triad dates. It was decided that doing so would not represent the typical risk profile, and would artificially alter the resulting base level of VAR. The group agreed;
- Due to PM's absence from the meeting, it was not possible for National Grid to present a timeline from the first missed payment through to a supplier's TNUoS liability profile dropping to zero. However WM and TT did indicate that the analysis had pointed more towards 3 missed payments than 2. KM's suggestion on using a process similar to that in the DCUSA (1½ months worth of payments) was also considered. It was agreed that this was inadequate as the group believed that two to three months was a typical period of time from missing a payment to a supplier's demands being transferred to an alternative supplier. The working group agreed that using two missed payments was the most appropriate level.

Action 1: PM to forward timeline of events following missed payments to the Working Group.

#### Security Periods & calculation of the Base Level of VAR to be secured

It was agreed that a fixed base level of VAR defined as a percentage of supplier forecasted annual liability shall be entered into the CUSC in relation to each security period, and not a methodology for calculating such a value.

WM gave a presentation of the potential scenarios discussed in the previous meeting:

Scenario 1: Basing the security periods on the maximum VAR profile (Commencing 15<sup>th</sup> August and 13<sup>th</sup> December);

Scenario 2: As scenario 1, except the second security period commences on 1st November;

Scenario 3: Security periods commencing 15th May and 2nd January (defined using the base VAR profile); and,

Scenario 4: Quarterly Security Periods;

Scenario 5: As scenario 1 with a third security period commencing on 1<sup>st</sup> April.

In each scenario the possibility of taking each of three methodologies for calculating the base level of VAR in each period was considered:

- a) The average value at risk of socialisation, indicated by the base VAR profile (i.e. an average of the base VAR profile collared at zero);
- b) An absolute average of the base VAR profile; and
- c) The maximum value at risk indicated by the base VAR profile.

It was decided that although the latter of these methodologies would be adequate in a commercial world, it could provide a barrier to new participants entering the market. As a result it was agreed that it was not appropriate.

The group decided that scenario 2 would result in inadequate security being provided during the winter period, as commencing the winter period when there is no significant risk was deemed to water down the effect of the base profile.

It was decided that although scenarios 1 and 5 provide security during all periods in which a significant risk is present, it was decided that any resulting average used to calculate the base level of VAR was still inadequate.

Scenario 3 was discounted by the working group because it did not provide a security requirement during enough of the periods in which a risk was present

Scenario 4 was chosen by the group as presenting the most adequate solution in terms of finding an appropriate balance between the level of VAR and providing security when risk is present.

The discussions then lead to whether or not to use a capped average (a) or an absolute average (b) of the Base VAR profile to determining the base levels of VAR to be contained within the CUSC.

The group agreed that netting HH and NHH VAR in each security period was appropriate. It was agreed that although using an absolute average would result in less security being provided during the first quarter of the year, it was the most appropriate solution as it allowed netting HH and NHH VAR without the introduction of complicated methodologies.

## Forecasting Performance

National Grid pointed out that in additions to concerns raised by KM in the previous meeting, the originally proposed solution could essentially penalise all suppliers in the event of a harsh winter, and proposed that 3% for NHH demands and 6% for HH demands should be subtracted from the resulting levels of forecasting performance. It was decided by the group that this would be carried out every year, as it would be difficult to determine a simple and accurate process to determine whether or not harsh weather had occurred.

National Grid presented a material doubt process to be used alongside the methodology that takes an average of forecasting performance of forecasts used to determine the last five monthly TNUoS bills.

A number of the working group members requested that National Grid prepare an explanatory note on how this process would work.

Action 2: WM to prepare explanatory note on how the material doubt process would work.

National Grid proposed that under the material doubt process, only appeals over greater than or equal to 1% of annual HH/NHH TNUoS liability would be considered, as it would be difficult to prove any increase in demand at a level less than this. Some working group members suggested that this amount should be far greater, as the example given in the previous meeting was of a supplier's liability increasing by approximately 20%. In addition concern was raised over the amount of appeals that would be received by National Grid and the amount of resources that it would take up if the level was set at 1%.

After some discussion it was decided that the minimum amount for any appeals considered by the material doubt process should be set logically and not an arbitrarily.

A suggestion of using an allowance was also made, a level under which a supplier would not be required to supply any additional security to the base level. It was pointed out that this would essentially lead to some suppliers under forecasting at a level just under the allowance, essentially creating a similar gaming issue to that currently being observed, but on a smaller scale.

Further to this, at least one of the working group members questioned whether or not the use of a material doubt process would be appropriate, as it was suggested that the event of a supplier taking on enough customers to be seriously penalised was "unexpected" and therefore rare.

In a note provided to the working group prior to the meeting KM suggested that average forecasting performance is taken using the average of the forecasts used to calculate the last two monthly TNUoS bills during the financial year. To gain a better grasp for the seriousness of the issue and a feel for what would be the most appropriate solution, a number of working group members requested that National Grid presented information on the severity of supplier under forecasting.

KM also pointed out in his note the need for transitional arrangements if moving to a forecasting performance model that provides significantly different incentives to suppliers than the current VAR calculation. The group agreed.

Action 3: WM to present anonymous analysis on forecasting performance during the latter part of 2005/06 on a company level.

Action 4: All working group members to consider three possible solutions and transitional arrangements in time for the next meeting:

1. 5 month average forecasting performance with material doubt process;
2. 5 month average forecasting performance without material doubt process;
3. 2 month average forecasting performance without material doubt process;

Finally National Grid asked the working group on views over whether or not the forecasting performance related VAR should be applied over all security periods for both HH and NHH liability. The group agreed that it should be applied over all security periods in both cases.

**Next Meeting**

10am, 22<sup>nd</sup> November at National Grid House, Warwick.