Douglas Alexander
Performance Assurance Board (PAB) Chairman
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14 November 2018

Dear Douglas,

I am writing to you as Chairman of Ofgem's Design Working Group (DWG). As you will be aware, the DWG is designing the Target Operating Model (TOM) for Market-wide Half Hourly Settlement (MHHS) as part of Ofgem's Significant Code Review on Electricity Settlement Reform.

**DWG deliverables and timescales**

The DWG reports to Ofgem's industry Design Advisory Board (DAB), Ofgem's internal TOM Board and the Ofgem Senior Responsible Officer (SRO). ELEXON is leading the DWG's design work on Ofgem's behalf. The key deliverables from the DWG to Ofgem are:

- A report to Ofgem in late January 2019, setting out the service requirements for the DWG's preferred TOM (to be followed by an industry consultation on this in February/March 2019);
- A transition approach for moving from the existing Settlement arrangements to the TOM, to be developed during Spring 2019 with an industry consultation in June/July 2019; and
- A final report to Ofgem in August 2019, to include the transition approach and estimated Settlement impacts/costs (based on an ELEXON impact assessment in June/July 2019).

You can find the DWG's Forward Work Plan and latest Gantt chart plan on its webpage. Ofgem intends to make its Final Business Case decision on how and when to proceed with MHHS during the second half of 2019. As part of its decision, Ofgem will consider the industry costs and impacts (including ELEXON's) of moving to the TOM. Changes to the BSC and other impacted Industry Codes will then be developed during 2020. Based on discussions to date, I currently anticipate a phased transition to the TOM with the potential for it to be fully effective from 2023. The DWG will confirm the detailed transition approach during Summer 2019, in line with the timetable above.

**Settlement timetable changes**

One of the Design Principles that Ofgem has set for the DWG is to consider how a reduced Settlement timetable, and reduced number of Reconciliation Runs, 'will create a settlement system which benefits all parties and maintains robust performance assurance'. This includes considering the extent to which a reduced Settlement timetable would reduce Credit Cover costs for existing Suppliers and new entrants. The Design Principle also supports one of Ofgem's strategic objectives for the TOM. This is that Settlement arrangements should 'become faster and more efficient, reducing the barriers to entry in the energy market'. Ofgem's measures for the success of MHHS include that the TOM should 'reduce the elapsed time required to complete the settlement of any given consumption period' and should reduce Credit Cover costs to participants.[1]

During Summer 2018, the DWG established a set of sub-workgroups to help it develop the TOM service requirements. It tasked one of these workgroups with establishing the most appropriate reduced Settlement timetable. You can find the workgroup's recommended timings in Attachment A to this letter. The key

[1] Ofgem's Strategic Objectives, Design Principles and measures for success can be found in Appendix 2A of Ofgem's SCR Launch Statement.

recommendations are that the Final Reconciliation (RF) Run would reduce to four months with the final Dispute (DF) Run cut-off to be 12 months or longer.

The DWG has discussed the workgroup's recommendations. It has also considered the steers from the Ofgem SRO and the DAB that:

- The DWG should pursue an ambitiously-shortened Settlement timetable that:
  - Reduces Credit Cover costs for participants; and
  - Provides appropriate incentives for the timely detection and correction of errors;
- The reduced Settlement timetable for the MHHS TOM should not be based on current market performance;
- The DWG should assume that the quality of Meter data under MHHS is better than now; and
- Trading Disputes should not be the norm, and should only be permitted in cases of significant materiality.

The DWG has found it challenging to assess the appropriate Settlement timetable for MHHS due to:

- The potential risks of overly-shortening the timetable as set out in Attachment A, and as captured in more detail within the DWG's Headline Reports from meetings 11 and 12;
- The difficulties in producing analysis that could predict future performance and the extent of any Settlement Risks under a reduced Settlement timetable;[2]
- The resulting uncertainty over the appropriate Performance Assurance Framework (PAF), and especially the performance targets, that would apply under the new timetable;
- The impacts of changing the Disputes process (including the cut-offs and materiality threshold for raising Trading Disputes) on Central Volume Allocation (CVA) errors, which fall outside the TOM's remit; and
- The risk that the DWG, whose members are not necessarily experts in the PAF or Disputes process, might design a MHHS PAF that conflicts with the work of the current PAF Review.

The DWG's January 2019 report to Ofgem will include its recommendations on the appropriate reduced Settlement timetable for MHHS. These are currently based on those of its workgroup, as set out in Attachment A. Although not yet developed, the DWG's approach for transitioning to the TOM is likely to include a phased move to this Settlement timetable as well as consideration of any necessary Settlement run-off arrangements.

**DWG's recommendations to the PAB**

The DWG, after significant discussion, has asked me to write to you with its recommendation that the PAB expands the scope of the PAF Review to consider the appropriate PAF for MHHS. The DWG recommends that this includes consideration of performance targets, the timing of the Disputes Run and a holistic review of the Trading Disputes process (particularly the materiality threshold).

Given the deadlines for the DWG's deliverables, this may include bringing forward the PAF Review's planned workstream on reviewing Performance Assurance Techniques (especially Supplier Charges) as well as initiating an additional piece of work on Disputes. I believe that the DWG will require clarity on the following by May 2019:

- What high-level assurance framework/principles will be needed to support MHHS;

[2] ELEXON has provided the DWG with PAB paper 208/15 'NHH Settlement by Meter type' and the Annual Performance Assurance Report for 2017/18. In addition, it has analysed the age and materiality of Settlement Errors (see DWG12 meeting slides) and the volume changes between Settlement runs in the Half Hourly market (published on the DWG13 webpage). It is currently working to analyse changes in GSP Group Take between Settlement runs.

- What elements of the PAF are no longer required, need to change, or needed to be introduced under the TOM;[3] and
- What DF Run cut-off and Disputes materiality threshold (or principles to determine the threshold) are appropriate for MHHS.

This will enable the DWG to include this information in its transition approach consultation in June/July 2019, as well as feeding into ELEXON's parallel impact assessment of the costs and impacts of the TOM. In turn, this will support Ofgem's Final Business Case decision in the second half of 2019.

The DWG, PAB and Ofgem will also need to consider how any changes to the PAF and Disputes rules fit into the wider SCR process – under which Ofgem intends to use its Smart Meters Act powers to make the necessary Industry Code changes.

Finally, the DWG notes the need to develop arrangements for monitoring and reporting participants' progress in transitioning to the TOM, including learning any relevant lessons from the implementation of P272 'Mandatory Half Hourly Settlement for Profile Classes 5-8'. This will require further discussion with the DWG, Ofgem and the PAB.

**Next steps**

I would be grateful if you could share this letter with the PAB and PAF Review team in the first instance.

I and Kevin Spencer from ELEXON will be happy to attend the November or December 2018 PAB meetings to give an overview of how the TOM may affect the PAF, answer any questions and discuss next steps. Please do not hesitate to let me know if you need any further information in the meantime.

Yours sincerely,

Kathryn Coffin

DWG Chairman

List of enclosures:

Attachment A – MHHS timetable considerations

[3] For example, Non Half Hourly Settlement arrangements will no longer exist under the TOM and all Meters will be settled Half Hourly (using Half Hourly 'load shapes' for customers without smart Meters or for whom actual Half Hourly Meter data is unavailable). This will have consequential changes to what the BSC considers to be 'estimated' or 'actual' Settlement data. In addition, the services supporting Settlement will look different to today's model.

# ATTACHMENT A: MHHS TIMETABLE CONSIDERATIONS

| Run name | Current timing | DWG's proposed timing | Purpose of run | Pre-requisites for run under MHHS | Benefits of shortening | Risks of shortening |
|---|---|---|---|---|---|---|
| Interim Information (II) Run | 4 WDs | 4 WDs | To detect CVA errors so that these can be corrected before the first financial run. | CVA Meter readings need to be collected. | Could enable quicker SF Run (see below). | Could reduce ability to identify/ correct CVA errors before SF Run. |
| Initial Settlement (SF) Run | 16 WDs | 5-7 WDs | First financial run.<br><br>Up to this point, BSC Parties must lodge Credit Cover for their estimated energy indebtedness. | SVA Meter readings need to be collected (dependent on DCC capability), and load shapes calculated to apply to Meters where readings aren't available. | Reduces the amount of Credit Cover that Parties need to lodge. | Overly shortening the run could:<br>• Result in significant DCC costs;<br>• Impact the ability to undertake the II Run;<br>• Create volatility between runs, if it means the SF Run is less accurate – thereby increasing the risk of bad debt; and/or<br>• Negate the benefit of the reduced timing if it means the run is less accurate and results in excess Credit Cover. |
| 1st Reconciliation (R1) Run | 39 WDs (~2 months) | 33 WDs (renamed as Interim Reconciliation Run) | Reconciliation against previous run as more SVA Meter readings become available and errors are identified/ corrected. | Readings from 'dumb' SVA Meters and any other SVA Meters where errors prevented data collection at SF. | See RF Run below. | N/A |

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|---|---|---|---|---|---|---|
| 2nd Reconciliation (R2) Run | 78 WDs (~5 months) | N/A – would not exist | Reconciliation against previous run as more SVA Meter readings become available and errors are identified/ corrected. | Not required under MHHS, on assumption that smart Meters will be read at least monthly and 'dumb' Meters quarterly. | See RF Run below. | Less runs may create more volatility between runs? |
| 3rd Reconciliation (R3) Run | 148 WDs (~7 months) | N/A – would not exist | Reconciliation against previous run as more SVA Meter readings become available and errors are identified / corrected. | Not required under MHHS, on assumption that smart Meters will be read at least monthly and 'dumb' Meters quarterly. | See RF Run below. | Less runs may create more volatility between runs? |
| Final Reconciliation (RF) Run | 14 months | 4 months | Final financial run.<br><br>Reconciliation against previous run based on final SVA Meter readings and corrected errors.<br><br>After this point, Trading Charges can only change as a result of a Trading Dispute. | Readings from 'dumb' SVA Meters and any other SVA Meters where errors prevented data collection at the Interim Reconciliation Run. | Quicker settlement of liabilities:<br>• Gives earlier certainty of charges.<br>• Enables quicker market exit.<br><br>Current R2 performance in HH market shows vast majority of Meters read by this point. | Overly shortening could lead to more Trading Disputes, if timescale insufficient to detect / resolve Settlement Errors.<br><br>While Parties could invest more resources in error detection / resolution, the costs of this could outweigh the benefits of a shorter timetable. |

# ATTACHMENT A: MHHS TIMETABLE CONSIDERATIONS

| Run name | Current timing | DWG's proposed timing | Purpose of run | Pre-requisites for run under MHHS | Benefits of shortening | Risks of shortening |
|---|---|---|---|---|---|---|
| Post-Final Settlement (DF) Run<br><br>Also known as 'Disputes Final' Run | 28 months | 12 months or longer | To correct Settlement Errors that could not be detected and/or resolved before the RF Run, and which meet specified BSC criteria. | Existence of Settlement Error that meets the criteria (including materiality threshold) for a Trading Dispute. | Gives incentives to Parties for timely detection and resolution of errors.<br><br>Less uncertainty for Parties of their final liabilities. | Overly shortening could:<br>• Result in significant uncorrected Settlement Errors (particularly in CVA market) that negatively impact Parties who did not cause them; and/or<br>• Create an asymmetry between the cut-offs for billing and Settlement adjustments (as Suppliers can back-bill by up to 12 months).<br><br>Parties causing errors that financially benefit them are not incentivised to correct them. A shorter cut-off may give less time for negatively-impacted Parties to raise Disputes. |