

Modification proposal:	Connection and Use of System Code (CUSC): Implementation of TNUoS charging parameter updates following a price control review (CMP214)		
Decision:	The Authority directs that CMP214 not be made		
Target audience:	National Grid Electricity Transmission plc (NGET), all transmission system users, parties to the CUSC and all other interested parties		
Date of publication:	19 December 2012	Implementation Date:	n/a

Background to the modification proposal

Transmission owners (TOs) deliver and maintain the infrastructure required by users seeking connection to, and use of, the electricity transmission network. Onshore, the size of the total revenue that these TOs can earn for providing transmission capability is determined by the price control formula set by Ofgem¹. The amount for each TO is determined every price control period and the revenue that each TO is seeking to recover in any financial year is recovered through Transmission Network Use of System (TNUoS) charges² administered by National Grid Electricity Transmission plc (NGET) in its role as System Operator (SO).

Following the conclusion of the recent price control review process of the three onshore TOs, RIIO-T1³, a number of the input assumptions to the TNUoS charging methodology ("the Methodology") are due to be updated in the first year of RIIO-T1 (2013/14). These updates allow NGET, in its role as SO, to form an up to date view of the costs of assets employed when providing transmission capability at different locations. This is one of the mechanisms that seeks to ensure that the Methodology remains cost reflective.

Some of the parameters due to be updated measure the costs of providing different types of transmission infrastructure asset and these underpin the calculation of the locationally varying component of the TNUoS tariff⁴. These are the expansion constant, which reflects the average unit cost of transmission across the network, and the different expansion factors, to reflect the relative costs of different voltages and circuit types. The weighted average cost of capital (WACC) and asset life assumptions are also due to be updated at this time.

The final value of these charging parameters is not fixed until the outcome of RIIO-T1 is known. Under the current Methodology, the effects of the changes to parameters dependent on the outcome of RIIO-T1 will take effect in the first year of the new price control period (2013/14). NGET considers that this timeline affects –

- users' ability to understand the full impact on TNUoS tariff levels applicable in 2013/14, and
- NGET's ability to communicate the full effect on TNUoS tariff levels for the next financial year (in draft form⁵ until at least late December 2012).

NGET also thinks that the current default notice period for the publication of final tariffs⁶ is insufficient to allow users to efficiently incorporate changes into their pricing structures in advance of the next charging year.

The modification proposal

NGET raised CMP214 on 25 October 2012. On 29 October 2012 the CUSC Modifications Panel requested that CMP214 should be treated as an urgent modification proposal by the Authority. We granted this request on 2 November 2012.

¹ Offshore TO revenues are determined following a commercial tender process, and are designed to provide an annual revenue stream for a fixed period.

² Calculated in accordance with the use of system charging methodology under standard licence condition (SLC) C4 ('Charges for use of system') of the electricity transmission licence.

³ The first electricity transmission price control to be set under the new Revenue=Incentives+Innovation+Outputs (RIIO) framework.

⁴ TNUoS tariffs are comprised of (i) a locational element to reflect the capital costs of shared transmission assets (ii) a non locationally varying element to ensure correct cost recovery. The combination forms the total TNUoS tariff.

⁵ Historically, to provide early visibility of the effect any movements in tariffs, NGET publish forecast TNUoS tariff levels in December. This has become custom and practice, but is not a requirement of the licence framework.

⁶ CUSC section 3.14.3 requires NGET to provide at least two month advance written notice of any revised charges.

CMP214 seeks to modify the Methodology to delay (by one year) the changes to financial parameters (expansion constant and factors, the WACC, and asset life assumptions) that are a result of RIIO-T1 and that are used in the derivation of the locationally varying component of the TNUoS tariff. The remainder of the Methodology used to calculate the locational and residual elements of TNUoS charges would remain unchanged.

The approach proposed by CMP214 means that updated values for these parameters will no longer take effect in the TNUoS tariff calculation in the first financial year of a new price control period, but instead take effect at the start of the second financial year of a new price control period. This includes the effect of these parameters on the configuration of generation charging zone boundaries. The proposed approach would also apply to the transition between all future price control periods.

The proposer considers that this approach will provide greater long-term visibility of changes to parameters which affect the derivation of the locational element of TNUoS tariffs and generation zones. The proposer thinks that this delay will improve predictability of individual TNUoS charges as it will allow users to more accurately forecast these components of the Methodology and reflect this in their pricing structures.

The proposal does not alter or delay updates to the level of annual allowed revenue determined by the outcome of Ofgem's price control review. Hence, the annual revenue collectable from TNUoS charges levied in the first financial year of a new price control period will seek to recover a level based on the outcome of that price control.

NGET will develop and communicate final TNUoS tariff levels for the next financial year (2013/14 in the case of RIIO-T1) in accordance with the default notification timescales required by the current regulatory framework (31 January). This approach will also apply to the transition between all future price control review periods. NGET will publish the values of the updated parameters to reflect the outcome of any review in December prior to the commencement of a new price control period. This will include the impact of these parameters on the configuration of generation charging zones.

The proposer considers that for a one year period (the first year of a new price control period) there will be a slight decrease in cost reflectivity as a result of the proposals, but that this is outweighed by the positive impact on competition as a result of increase in predictability for all users. Furthermore, the proposer thinks that the extended notice period of the final value of parameters used to derive the locational element of TNUoS charges may assist in the provision of a long term stable charging signal to users.

CUSC Panel recommendation

The Panel voted on CMP214 at its meeting on 27 November 2012. No alternative proposals were made. The majority of the Panel voted that the original proposal better met the relevant objectives and so should be implemented. On 30 November 2012, the Panel submitted a Final Modification Report ("the Report") on CMP214 to us for a decision.

The Authority's decision

We have considered the issues raised by the proposal as set out in the Report. We have considered and taken into account the responses to the Code Administrator consultation, which are attached to the Report. We have concluded that:

1. on balance, the proposal would not better facilitate the achievement of the relevant objectives; and
2. the proposal should not be made. This is consistent with our principal objective and wider statutory duties⁷.

⁷ The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed in the Gas Act 1986, the Electricity Act 1989 and the Utilities Act 2000, all as amended.

Reasons for the Authority's decision

In making our decision, we have considered the views of the proposer, Panel members and consultation respondents. We set out below our reasoning against each of the relevant objectives.

Objective (a) 'that compliance with the use of system charging methodology facilitates effective competition in the generation and supply of electricity and (so far as is consistent therewith) facilitates competition in the sale, distribution and purchase of electricity'

In principle we support increased predictability of changes in annual TNUoS tariff levels. We consider that increased predictability should reduce cash flow risks on generators and suppliers and lower potential barriers to entry in the market. We expect that this should increase the level of competition. This may be particularly beneficial for smaller suppliers.

However, we do not think it has been demonstrated (in this case) that the modification would provide these benefits, due to the process that has been followed by NGET and the expectations of stakeholders.

In addition to the established measures to enable users to make estimates of future tariff levels⁸, we note that NGET has provided updates and presented analysis to the industry methodology forum⁹ (including the impact on generation zone boundaries) and published other information sources on its website¹⁰ to help stakeholders understand potential tariff movements based on developments throughout the RIIO-T1 process. These developments include the finance package included in NGET's Initial Proposals, published in July 2012¹¹, and the Final Proposals for the two Scottish TO's, published in April 2012¹². These have all been based on the existing Methodology (i.e. changes to parameter values will take effect in the first year of the new price control period).

This has given industry participants an expectation that these changes will proceed and we expect that parties will have made their own assumptions in this area to reflect the outcome of the RIIO-T1 process. We therefore expect the tariffs set by suppliers will have reflected these expectations.

To change the basis of the interaction between the Methodology and the established charge setting process applied by NGET at such a late point in the charging year would likely lead to windfall gains and losses for generators and suppliers with limited opportunity for any change in behaviour likely. It is also possible that this could introduce additional uncertainty and so undermine confidence in the predictability of TNUoS charges (and reduce competition in the long run).

We also note that there are a number of other factors that contribute to the development of TNUoS tariffs and affect the predictability of changes in annual TNUoS tariff levels. These include (i) changes to annual revenue collectable through TNUoS charges, and (ii) underlying changes in the configuration of the transmission system¹³. Prior to the commencement of a

⁸ NGET provides users with the model used to calculate tariffs. Along with available price control information, the data from the Seven Year Statement, and their own prediction of activity, users are able to perform sensitivity analysis.

⁹ NGET presented analysis on the potential changes to tariffs to the Methodology Forum meetings in May and September 2012, available from NGET's website.

¹⁰ See: "Initial view of TNUoS tariffs for 2013/14": http://www.nationalgrid.com/NR/rdonlyres/E4BFA3A5-8920-441F-8C76-41B3C6F155A7/53213/InitialViewofTNUoSTariffsin13_14.pdf and "Updated view of Electricity TNUoS tariffs for 2013/14": http://www.nationalgrid.com/NR/rdonlyres/5432E94D-D903-45E2-BA33-B103103EEC9A/57567/UpdatedforecastofTNUoSTariffsin13_14.pdf

¹¹ See: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=211&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes>

¹² <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/SPTSHETLFP.pdf>

¹³ This category includes changes in the topography of the transmission network, changes in the configuration of generation and demand at different locations, and the forecast level of peak demand on the network.

new price control period, movements in tariffs will be driven by changes in all of these parameters.

Based on the analysis presented and the responses to the Code Administrator consultation, we do not think it has been demonstrated that the proposal will increase predictability of charges in the manner stated (for the next financial year, 2013/14) and therefore would not be expected to better facilitate competition in the generation and supply markets. In future years (i.e. at the next price control) we think these benefits would be there (as expectations would be different given the lead times) but these are outweighed by the more immediate impact of the proposed approach in the next financial year (2013/14).

We consider that, on balance, CMP214 does not better facilitate this objective relative to the baseline.

Objective (b) 'that compliance with the use of system charging methodology results in charges which reflect, as far as is reasonably practicable, the costs (excluding any payments between transmission licensees which are made under and in accordance with the STC) incurred by transmission licensees in their transmission businesses and which are compatible with standard condition C26 (Requirements of a connect and manage connection)'

We consider that, on balance, CMP214 does not better facilitate this objective for reasons similar to the majority of the CUSC panel. We consider that introducing a one year delay in the updating of specific cost input values (and consequential impact on changes to the configuration of generation zones) would reduce cost reflectivity relative to the baseline. This impact would be repeated with the commencement of each new price control period, and for changes to parameters that can either increase or decrease the range of locational differentials. However, we recognise that the potential reduction in cost reflectivity is not significant and agree that it would not materially impact the effectiveness of the long term investment signal provided by the Methodology.

Objective (c) 'that, so far as is consistent with sub-paragraphs (a) and (b), the use of system charging methodology, as far as is reasonably practicable, properly takes account of the developments in transmission licensees' transmission businesses'

We consider that the introduction of CMP214 is neutral to this objective as we do not consider the parameters that are the subject of the CMP214 approach represent a development in the TOs' transmission businesses.

The proposer considered that CMP214 represents an improvement under this objective on the basis that it reflects the policy intent of Ofgem's recent consultation and decision on network charging volatility issues arising from the price control settlement¹⁴. We would point out that the decision did not seek to address charging methodology issues and instead focused on changes to allowed revenue and the impact of regulatory incentives on this. We therefore see the issues as being separate.

Assessment having regard to the Authority's statutory objectives and duties

We have considered whether implementation of CMP214 is consistent with our principal objective and statutory duties. In our view, the proposal will reduce the cost reflectivity of charges in all transition periods between price controls relative to the baseline, but not significantly. This is linked to the fact that under the current Methodology, the effects of the changes to parameters dependent on the outcome of a price control review will take effect in the first year of the new price control period. We also consider that the proposal will not have a material impact on sustainable development and security of supply.

¹⁴ See Ofgem's consultation published in April 2012:

http://www.ofgem.gov.uk/Networks/Policy/Documents1/Charging_Volatility_Cons.pdf

We are not unsympathetic to the aim of this modification. We acknowledge that as a general principle the industry would like as much clarity and prior warning of changing costs. We also recognise that during the transition between price control periods the value of certain parameters will not be known in their final form until the outcome of the review process. Greater certainty should promote competition in the generation and supply of electricity. However, to facilitate the achievement of these potential benefits a modification to the Methodology would need to be developed and raised in sufficient time to be efficiently incorporated into the charging forecasts that affect pricing structure decisions. We think the analysis presented and views of industry parties supports this broad view.

We encourage industry to consider these issues on a more timely basis going forward. It also would seem appropriate for industry to further consider the appropriateness of the current Methodology and its interaction with the current contractual framework given that we are now moving towards an extended (eight year) price control period.

Decision notice

In accordance with standard condition C5 of NGET's Transmission Licence, the Authority hereby directs that modification proposal CMP214 '*Implementation of TNUoS charging parameter updates following a price control review*' not be made.

Andrew Burgess

Associate Partner, Transmission and Distribution Policy

Signed on behalf of the Authority and authorised for that purpose