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Direct Dial: 020-7901-7040

13 April 2004

The National Grid Company, CUSC Signatories and
Other Interested Parties

Your Ref: CAP055
Our Ref: IND/COD/CUSC/CAP055

Dear Colleague,

Amendment to the Connection and Use of System Code (“CUSC”) - Decision and notice in relation to Proposed Amendment CAP055: “Users’ Demand Forecasts TNUoS Charging”.

The Gas and Electricity Markets Authority (the “Authority”¹) has carefully considered the issues raised in the Amendment Report² in respect of Proposed Amendment CAP055 “Users’ Demand Forecasts TNUoS Charging”.

The National Grid Company plc (“NGC”) recommended to the Authority that Proposed Amendment CAP055 should be approved.

The Authority has decided to direct a modification to the CUSC.

This letter explains the background to Proposed Amendment CAP055, as set out in the Amendment Report, and sets out the Authority’s reasons for its decision. This letter also constitutes the notice by the Authority under Section 49A of the Electricity Act 1989 in relation to the direction.

An attached letter contains a direction to NGC to modify the CUSC in accordance with Alternative Amendment (A) as set out in the Amendment Report.

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

² CAP055 Amendment Report dated 28 January 2004

Background

The Proposer of Amendment Proposal CAP055 stated that for the purposes of NGC calculating TNUoS tariffs and User's specific demand charges, Paragraph 3.10 of the CUSC places a requirement upon Users to submit forecasts to NGC. However, the CUSC is not prescriptive in terms of the quality of data required for forecasting purposes and the Proposer is therefore of the opinion that the implementation of CAP055 would protect the industry from the effects of failing suppliers who may have under-paid TNUoS charges as a result of poor-quality forecasting.

Amendment Proposal CAP055 was raised by NGC on 18 September 2003 and was submitted for consideration to the CUSC Amendments Panel Meeting on 26 September 2003. At the meeting, the Amendments Panel determined that the Amendment Proposal CAP055 should be evaluated by a Working Group. The Working Group provided a final report to the Amendments Panel on 21 November 2003. The Amendments Panel agreed that CAP055 should proceed to wider industry consultation. The consultation paper was issued on 28 November 2003 with responses invited by 4 January 2004. The Amendment Report was submitted to the Authority on 28 January 2004.

The Proposed Amendment

Proposed Amendment CAP055 seeks to amend the CUSC in respect of clarifying the obligations of Users regarding the quality and accuracy of demand forecast data supplied for TNUoS Charging purposes.

Section 3.10 of the CUSC places an obligation upon Users to supply NGC with such data as to enable NGC to calculate TNUoS charges and that this data should be submitted on or before the end of the second week of December in each financial year. However, the Proposer of CAP055 was concerned that some suppliers have submitted inaccurate forecasts and that the CUSC currently places no obligations upon users regarding the accuracy of the data they supply to NGC for these purposes.

CAP055 was therefore raised to address this possible defect and grant NGC the option to reject any forecasts considered to be unreasonable and, where necessary, to replace these forecasts with their own estimates. The Proposer also considered that were such an amendment to be made to the CUSC, this would result in greater protection for the industry as a whole in addressing the non-payment of TNUoS charges arising from failing Suppliers.

To address this defect, the Proposer considered that a satisfactory remedy would be to amend Paragraph 3.10 of the CUSC to the effect that an improvement in the quality of any forecast data supplied by Users should, in addition to the current requirement, be subject to strict timescales regarding its submission. As a direct consequence of this, the Proposer considered that Paragraphs 3.11; 9.10.2 and 9.10.3 of the CUSC should also be amended with further changes being incorporated within the appropriate Charging Statements to better facilitate the achievement of such an amendment.

The Proposer considered that Proposed Amendment CAP055 would better facilitate achievement of the Applicable CUSC Objective C7F.1 (a) and C7F.1 (b) for the efficient discharge by NGC of the obligations imposed upon it under the Act and by its Transmission Licence³.

Working Group's views

At their meeting on 26 September 2003, the Amendments Panel determined that Amendment Proposal CAP055 should be evaluated by a Working Group.

In arriving at their conclusions, the Working Group assessed the Amendment Proposal against the Applicable CUSC Objectives. It was the view of the Working Group that the Amendment Proposal would lead to improved monitoring of User's TNUoS payments against actual TNUoS liabilities and that this would have the effect of providing more cost reflective charges, reducing the exposure of the industry to bad debt and in so doing, promote more effective competition within the electricity market. The Working Group was of the opinion that such benefits to the industry as a whole significantly outweighed the negligible rise in the administrative costs of NGC.

In assessing the extent and implications of the defect, the Working Group considered the possible level of exposure of NGC and industry and the risk of supplier failure arising from the submission of inaccurate demand forecasts. The Working Group was of the opinion that because supplier failure could impact upon the industry as a whole, the need for a more robust procedure to facilitate the recovery of TNUoS charges throughout the year was required. The Working Group therefore developed a process agreed as being acceptable for the submission and validation of demand forecasts⁴. The Working Group considered that a divergence of 20% between the Users' demand forecasts and NGC's own demand forecast would not be an unacceptable level of inaccuracy in the light of what would normally be expected when allowing for unexpected changes in a user's demand.

The Working Group then identified as a risk that this mechanism may incentivise suppliers to consistently under-forecast where this had not previously been the case. As a result, the Working Group did not believe that this strategy could be employed effectively and could be remedied by a further amendment proposal to tighten the proposed 20% deviation. The Working Group had considered the accuracy of NGC's demand forecasting methodology and concluded that this was an objective and reasonably accurate.

³ The Applicable CUSC Objectives are contained in Standard Condition C7F of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 (the "Transmission Licence") and are:

- (a) the efficient discharge by the licensee of the obligations imposed upon it under the Act and by this licence; and
- (b) facilitating effective competition in the generation and supply of electricity, and (so far as consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity.

⁴ CAP055 Working Group Report dated 14 November 2003

The Working Group agreed that, to enable NGC to properly validate and possibly query demand forecast submissions, CAP055 should seek to ensure that information is received by NGC by the 10th of the month as opposed to the current requirement of submitting data on the 15th March and quarterly thereafter. In the event that CAP055 is to be accepted by the Authority, the Working Group suggested that the proposed methodology should reside within the Charging Methodology Statement with reference made to this within the relevant section of the CUSC.

The Working Group considered that new Users should adhere to a similar process with one notable exception. NGC would accept the new Users' demand forecasts in determining TNUoS charges until receipt of the first quarterly non-zero demand data, after which the same standard procedures should apply.

In addition to the above findings, the Working Group also considered other alternatives to address the defect identified in CAP055. These included incentivised reconciliation, periodic NHH reconciliation and within-year security cover. The Working Group did not consider that any of these alternatives would better facilitate achievement of the CUSC Objectives.

The Working Group provided a final report to the Amendments Panel on 21 November 2003 which contained their main conclusions.

Respondents' views

NGC issued a consultation paper on 28 November 2003 inviting views from CUSC Parties and interested parties.

NGC received four responses to the consultation in respect of the Amendment Proposal, all of which were supportive of CAP055. The Amendment Report contains the complete text of all respondents' replies.

To negate the possibility of unreasonable demands being placed upon Users, one respondent stressed the need for dialogue between National Grid and Users following the proposed implementation of CAP055.

A further respondent believed that the profiling of forecasts by Suppliers should be achievable by submitting quarterly variable forecasts.

Whilst supporting the purpose of the Proposed Amendment, one respondent suggested that it would have been useful for National Grid to identify how many Suppliers had exceeded their actual demand forecasts and to what extent this may reverse any under-recovery stated by National Grid. The same respondent also considered it important for individual Users to have the right to appeal against any National Grid determination and for the implementation date of the Amendment Proposal to become effective from 1 April 2004. The same respondent also raised Alternative Amendment (A).

Alternative Amendment (A)

Alternative Amendment (A) offers a revision of the wording in paragraphs 3.10.1 and 9.10.4.1 of the Amendment Proposal by stating that estimates provided by users should be “reasonable estimates” as opposed to their “best estimate” as prescribed in the original Amendment Proposal. In compliance with the procedural requirements of the CUSC, further consultation in relation to Alternative Amendment (A) resulted in the receipt of a further two responses, one by the originator of Alternative Amendment (A). The additional respondent was of the opinion that it was difficult to distinguish between the definitions of “best” and “reasonable” and for this reason did not support Alternative Amendment (A).

The respondents’ views are summarised and contained in the Amendment Report in respect of Proposed Amendment CAP055.

Amendments Panel Members’ views

One response was received by an Amendments Panel Member to the consultation in support of the Amendment Proposal.

NGC’s recommendation

NGC recommended to the Authority that Proposed Amendment CAP055 should be approved with an implementation date of 16 February 2004 or 10 days after the Authority’s decision. NGC considers that Proposed Amendment CAP055 will better facilitate achievement of the Applicable CUSC Objectives.

GB Consultation Respondents’ Views

The Authority received two responses following the publication of a letter dated 28 January 2004 inviting views regarding the possible implications of CAP055 on a GB Wide basis.

The first of these supported the Proposed Amendment and added that the intended benefits can also be applied to the GB Transmission system under BETTA.

The second respondent was of the opinion that CAP055 would increase the level of influence that NGC has in relation to small suppliers. The same respondent also suggested that, were the Proposed Amendment accepted, this would imply that NGC’s own forecasts are deemed to be accurate resulting in minimal reconciliation at the end of the year. As a direct result, this respondent was of the opinion that CAP055 should not be accepted without a review of security cover also being addressed.

Ofgem's view

Having had regard to its statutory duties, the Applicable CUSC Objectives and the consultation responses provided, Ofgem considers that the achievement of the Applicable CUSC Objectives would be better facilitated if the current version of the CUSC were amended to incorporate the changes detailed in the Alternative Amendment (A). Having considered the Amendment Report and having observed the evaluation of the Working Group, Ofgem considers that efficiency gains and improved cost reflectivity would be gained if NGC could expect reasonably accurate Demand Forecast Data from Users for the purposes of NGC calculating TNUOS tariffs and Users specific demand charges.

Alternative Amendment (A)

Ofgem considers that Alternative Amendment (A) would assist NGC to efficiently discharge the obligations imposed upon it under the Act and the Transmission Licence through the ability to use more accurate demand forecasts when calculating TNUoS charges and thereby reducing the risk to the industry from the failure of Users who may submit inaccurate low demand forecasts. Ofgem therefore considers that this would better facilitate achievement of objective C7F.1.(a).

Ofgem considers that it is important that in the interests of the industry as a whole, each User should endeavour to provide reasonable estimates of Demand Forecast Data from Users. Ofgem considers that the obligation to provide reasonable estimates a cost-effective and equitable mechanism. Ofgem also has considered the difficulties Users may encounter in preparing demand forecasts. As such, Ofgem considers that Users will be better able to provide "reasonable estimates" rather than "best estimates".

The Proposed Amendment

However, the Proposed Amendment requires Users to provide "best estimates" for their demand forecasts. In this regard, Ofgem considers that an obligation on Users to provide NGC with such "best estimates" in all such circumstances may prove inappropriately onerous and considers that the Alternative Amendment (A) solution to provide reasonable estimates strikes the better balance between the commercial imperatives of parties and NGC's efficiency considerations.

Further, the Authority considers it essential that all interested parties adopt a constructive approach to discussing any differences in estimates that may arise, with NGC giving due consideration to the explanations provided by Users when justifying their data submissions. In the event of inability to resolve differences, Ofgem considers that the Dispute Resolution Process provides a satisfactory mechanism to address any differences.

For CAP055 Alternative to be implemented successfully, Ofgem considers it essential that NGC maintain a productive and positive working relationship with all relevant data submitting Users on this issue and try to ensure that the Dispute Resolution Process is only referred to in exceptional circumstances. The Authority would like to emphasise that it is the responsibility of individual participants to try to ensure that the trading arrangements are able to operate as efficiently as possible

In addressing the concern raised by one respondent regarding the level of securitisation required by Users following the possible implementation of CAP055, Ofgem considers that neither the

Proposed Amendment nor the Alternative Amendment will significantly impact upon the current industry credit arrangements. Ofgem believes that the proposals described as part of CAP055 do not necessitate a review of these arrangements but would welcome the discussion of such issues as part of the wider industry consultation currently being facilitated.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'A. N. Simpson', written over a horizontal line.

Nick Simpson

Director, Modifications

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