



Direct Dial: 020 7901 7412

31 May 2002

The National Grid Company, CUSC Signatories and
Other Interested Parties

Your Ref: CAP019

Our Ref : IND/COD/CUSC/CAP019

Dear Colleague

Amendment to the Connection and Use of System Code (“CUSC”) - Decision and Direction in relation to Proposed Amendment CAP019: “Reactive Power Default Payment Rate Mechanism”

The Gas and Electricity Markets Authority (the “Authority”) has carefully considered the issues raised in Amendment Report CAP019 “Reactive Power Default Payment Rate Mechanism”.

The National Grid Company plc (“NGC”) has recommended to the Authority that CUSC Proposed Amendment CAP019 be approved and implemented with effect from five days after the Authority’s decision or 1 May 2002 (whichever is the later date).

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

This letter explains the background to the Proposed Amendment and sets out the Authority’s reasons for its decision. In addition, the letter contains a direction to NGC to modify the CUSC as set out in the Proposed Amendment. This letter constitutes the notice by the Authority under Section 49A of the Electricity Act 1989 in relation to the direction.

Background to the proposal

All licensed generators are required to provide the mandatory reactive power System Ancillary Service as set out under CC.8.1 of the Grid Code. This service is referred to as the Obligatory Reactive Power Service (“ORPS”) in Schedule 3 of the CUSC.

All providers of the ORPS are paid utilisation payments via a default mechanism in accordance with Schedule 3 of the CUSC. Prior to the introduction of the CUSC, these payment rules were detailed in the Master Connection and Use of System Agreement (“MCUSA”). Under the MCUSA, indexation of the default payment for ORPS was frozen from 31 March 2001. The Reactive Power Market Working Group conducted a review of the indexation factor to apply

from this point on. The review was completed in September 2000 and its recommendation was to continue to index the default payment rate for reactive power in line with the Retail Prices Index ("RPI"). In March 2001, at the request of the Transmission Users Group, NGC referred to Ofgem for determination a variation to the MCUSA in order to implement this proposal. The proposed MCUSA variation sought to continue RPI indexation of default payment rates for reactive power for a further two years (i.e. until 31 March 2003). In June 2001, Ofgem concluded that default payments for the provision of ORPS should continue to be indexed in line with the proposed MCUSA variation.

In making this determination Ofgem stated the view that RPI indexation of reactive power default payments was not an appropriate long-term solution. Ofgem accepted that the costs of reactive power relate to an increase in maintenance requirements and a reduction in overall efficiency. Ofgem concluded that whilst costs associated with maintenance may be linked to RPI, additional fuel costs associated with lower efficiency are not directly linked to RPI. Ofgem suggested that if indexation were to be applied, it would be more appropriate to use a basket of indices that better reflect the costs of providing Reactive Power. Ofgem was of the view that the extension of the indexation arrangements for a further two years would allow sufficient time to review the indexation issue and introduce enduring arrangements through the CUSC amendment process.

Following this MCUSA variation, the current provisions for indexing the reactive power utilisation default payment rate are due to expire on 31 March 2003. The next reactive power market tender round (Tender Round 10) is for contracts with effect from 1 October 2002 with a minimum duration of 1 year. Consequently, any contracts entered into through this tender round will apply in the period beyond 31 March 2003 for which no indexation provisions apply. Tenders for Tender Round 10 need to be submitted on or before 31 May 2002.

The Balancing Services Standing Group ("BSSG"), which was established under the CUSC, was actioned to consider the current approach to the procurement of reactive power and identify areas for development. In particular, the BSSG was actioned to review the issue of default payments for Reactive Power in light of the Ofgem determination on the MCUSA variation referred to above.

However, appropriate enduring arrangements beyond March 2003 in relation to the default payments issue have not been addressed through the CUSC amendment process. The Secretary of State designated the CUSC on 25 June 2001 and it was due to be implemented on 18 July 2001. However, implementation was delayed until 18 September 2001 at the request of industry participants.

On 14 March 2002 Innogy raised Amendment Proposal CAP019: "Reactive Power Default Payment Mechanism".

The Proposed Amendment

Proposed Amendment CAP019 proposes that the current provisions for indexing the default payment rate for reactive power utilisation, which are due to expire on 31 March 2003, are extended for a further year so that they apply until 31 March 2004.

The Proposer suggested that the Proposed Amendment removes uncertainty from the next two reactive power market tender rounds caused by the absence of indexation post 31 March 2003. Furthermore, the extension provides additional time for an enduring methodology for indexing default reactive payments to be established. Therefore, the Proposer believed that Proposed Amendment CAP019 better facilitates the achievement of the applicable CUSC Objectives¹.

The BSSG considered three options relating to the indexing provisions during its discussion of Proposed Amendment CAP019 as follows:

- No indexation to default payment. The BSSG believed that the current market tender arrangements had not evolved sufficiently to rely on the market arrangements alone and therefore dismissed this option.
- Apply RPI indexation to default payment indefinitely. Mindful of Ofgem's view that continuing use of RPI indexation was not appropriate, the BSSG rejected this option.
- Apply a combination of RPI indexation and fuel-based indexation. RPI indexation could be applied to reflect additional maintenance costs and fuel-based indices would reflect reduced efficiency. The BSSG felt that this option required further debate and a firm proposal could not be made in time for tender market Round 10.

In light of these factors, the BSSG supported Proposed Amendment CAP019 and believed that the indexation issue would be addressed in conjunction with the wider issues associated with procuring reactive power during the one-year extension.

NGC issued a Consultation Report on 28 March 2002 which invited views from CUSC Parties and interested parties by 15 April 2002.

Respondents' views

In total, NGC received 7 responses to the consultation on Proposed Amendment CAP019. Of the respondents, six expressed support for the Proposed Amendment and the remaining respondent was neither in favour of nor opposed to the Proposed Amendment.

The respondents in favour of the Proposed Amendment felt that it would remove the uncertainty linked to the imminent tender rounds thereby encouraging competition in these rounds. The one-year extension was seen as an appropriate solution given the limited timescale before the next tender round. The extension was further supported because it allows sufficient time for the BSSG and the wider industry to develop and evaluate alternative methodologies for an enduring solution.

One of those in favour highlights two specific reasons for considering a further extension of the current indexation arrangements. Firstly, the Ofgem determination on the MCUSA variation was partly retrospective. Secondly, the period before the deadline for submission of tenders for

¹ The applicable CUSC Objectives are contained in paragraph 1 of Supplementary Condition C7F of NGC's 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 is consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity.

Round 10 in which a long-term solution was to be developed was further shortened by the unforeseen delay in the implementation of the CUSC.

One respondent acknowledged that the development of an alternative to RPI indexation has been limited. However, the respondent believes that it would be inappropriate for providers to be penalised because progress on the issue has been limited.

Amendments Panel Members' Views

It was the opinion of those CUSC Amendments Panel Members who expressed a view that Proposed Amendment CAP019 should be implemented to the timescales recommended.

NGC's Recommendation

NGC recommended that the Authority should approve the Proposed Amendment and that, if approved, the Proposed Amendment should be implemented with effect from five days after the Authority's decision or 1 May 2002 (whichever is the later date). NGC made this recommendation on the basis that it believed that Proposed Amendment CAP019 better facilitates the achievement of the applicable CUSC Objectives.

NGC believed that extending the indexation for a further year removes uncertainty from the next reactive market tender rounds thereby further encouraging competition in the reactive power market. NGC considered that this enabled it to discharge its obligations under the Electricity Act 1989 and the Transmission Licence and to facilitate 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.

In support of its recommendation NGC reiterated the reasons for a one-year extension of RPI indexation. NGC highlighted that the Ofgem determination on the MCUSA variation, which allowed a two-year extension to RPI indexation, was partly retrospective. Additionally, NGC argued that no progress could be made on this issue until after implementation of the CUSC. Given the deadline of 31 May 2002 for the submission of tenders for Round 10, NGC considered that this left a window of approximately 6 months for a solution to be developed by the BSSG. However, NGC argued that during this period frequency response issues related to CUSC Amendment Proposals CAP001², CAP009³ and CAP010⁴ have dominated the work of the BSSG. Therefore, NGC commented that while it does not support RPI indexation of the reactive power default payment indefinitely, it is necessary to remove uncertainty from the next two reactive power tender rounds.

NGC supported the current initiatives within the BSSG to review the existing situation and introduce more appropriate enduring arrangements as soon as possible. In respect of the long-term solution, NGC commented that it does not regard RPI indexation as the most appropriate solution. NGC noted the interaction of this issue with its System Operator incentive scheme under which the target for incentivised balancing costs is not subject to any indexation.

² CAP001: "Frequency Response Imbalance Payments"

³ CAP009: "Mandatory Frequency Response"

⁴ CAP010: "Frequency Response Imbalance Exposure"

The Amendment Report was submitted to the Authority for decision on the 29 April 2002.

Ofgem's view

Ofgem⁵ considers, having had regard to its statutory duties, that Proposed Amendment CAP019 does better facilitate the relevant objectives of the CUSC.

In June 2001, Ofgem stated that it did not regard RPI indexation of default payments as appropriate and stressed that an alternative long-term solution needed to be developed. It is worth noting, as highlighted by NGC, that RPI indexation has been removed from NGC's incentive scheme because it was not considered appropriate to apply a general price index given the economic drivers of many of the cost streams that make up the incentive schemes. Ofgem is still of the opinion that RPI indexation of default payments is inappropriate and Ofgem considers that more appropriate enduring arrangements should be developed.

However, Ofgem recognises that there was a delay in the implementation of CUSC which shortened the period for consideration of enduring arrangements for default payment indexation. Ofgem additionally recognises that the BSSG, which was actioned to review the issue of default payments for Reactive Power in light of the Ofgem determination on the MCUSA variation, has spent a considerable period of time progressing the frequency response Amendment Proposals. Ofgem recognises that together these factors have left a limited period in which a long-term solution could be developed.

However, given that at present an enduring solution has not been developed, Ofgem is of the opinion that a one-year extension to the current RPI indexation of default payments better facilitates the achievement of the applicable CUSC Objectives. Ofgem considers that the extension will remove uncertainty in relation to the default payment from the next two market tender rounds, thereby encouraging competition. Ofgem considers that this enables NGC to discharge its obligations under the Act and the Transmission Licence and facilitates effective competition in the generation and supply of electricity, and (so far as is consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity.

Ofgem considers that a one-year extension to the existing default arrangements will allow sufficient time for an alternative method of default payment indexation to be developed. While approval of Proposed Amendment CAP019 extends the applicability of the current RPI indexation until 31 March 2004, Ofgem strongly urges the development of an appropriate indexation method to replace the current RPI indexation prior to this date. The BSSG is actioned to consider these developments, although any CUSC signatory can submit an Amendment Proposal to address reactive power issues at any stage. Therefore, Ofgem would not expect, other than in exceptional circumstances, that any proposal for extending RPI indexation beyond 31 March 2004 would better facilitate the applicable CUSC Objectives.

Ofgem takes this opportunity to reiterate that it views development in the procurement of reactive power as an important area of work and as such welcomes the commitment of the BSSG to review the current situation and introduce more appropriate enduring arrangements as soon as possible.

⁵ Ofgem is the office of the Authority. The terms "Ofgem" and "the Authority" are used interchangeably in this letter.

The Authority's decision

The Authority has therefore decided to direct that Proposed Amendment CAP019 should be made and implemented.

Direction under Condition C7F.7(a) of NGC's Transmission Licence

Having regard to the above, the Authority, in accordance with Condition C7F.7(a) of the licence to transmit electricity treated as granted to NGC under Section 6 of the Electricity Act 1989 as amended (the "Transmission Licence"), hereby directs NGC to modify the CUSC as set out in Proposed Amendment CAP019.

The modification is to take effect from 5 days after the Authority's decision or 1 May 2002 (whichever is the later date).

In accordance with Condition C7F.7(b) of NGC's Transmission Licence, NGC shall modify the CUSC in accordance with this direction of the Authority.

Please do not hesitate to contact me on the above number if you have any queries in relation to the issues raised in this letter or alternatively contact Anthony Doherty on 020 7901 7159.

Yours sincerely



Sonia Brown

Head of Electricity Trading Arrangements

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

Attachment 1

Legal Text to give effect to the Proposed Amendment

Changes to CUSC Schedule 3 (Appendix 1, Clause 3) as follows:

3. Indexation

The indexation factor I used in the formulae in paragraph 2 above shall with effect from 1st April in respect of each subsequent twelve month period ending 31st March, be determined as follows:-

$$I = \frac{RP1_2}{RP1_1}$$

where

For the period from (and including) 1st October, 1997 to (and including) 31st March, 1998 $RP1_2 = 155.4$, and thereafter $RP1_2$ is the RPI for March of the immediately preceding twelve month period ending 31st March.

$RP1_1$ is the RPI for March, 1994 (142.5).

The index used is the Retail Price Index (RPI) with 1987 = 100 base. The source of the RPI index is the monthly Department for Education and Employment "Employment Gazette".

~~Save as may otherwise be determined by the Authority pursuant to a reference made by NGC under the Transmission Licence to settle a dispute arising out of the variation provisions of Schedule 5 to the MCUSA, in respect of all periods from (and including) 1st April, 2004 the indexation factor I applicable for the period from (and including) 1st April, 2003 to (and including) 31st March 2004 shall apply.~~