Align annual connection charge rate of return at CUSC 14.3.21 to price control cost of capital




Lee Wells
lee.wells@northernpowergrid.com

Connection charging methodology

Extract from standard condition C6 of the transmission licence

8. The connection charging methodology shall make provision for connection charges for those items referred to in paragraph 4 to be set at a level for connections made after 30 March 1990 which will enable the licensee to recover:

> *(a) the appropriate proportion of the costs directly or indirectly incurred in carrying out any works, the extension or reinforcement of the national electricity transmission system or the provision and installation, maintenance and repair or (as the case may be) removal following disconnection of any electric lines, electric plant or meters; and*
>
> *(b)* ***a reasonable rate of return on the capital represented by such costs****,*

and for connections made before 30 March 1990 to the licensee's transmission system, the connection charging methodology for those items referred to in paragraph 4 shall as far as is reasonably practicable reflect the principles of sub-paragraphs (a) and (b).

Broadly speaking, a Relevant Transmission Licensee can set its connection charging methodology so it can recover:

Its directly or indirectly incurred costs; and

A reasonable rate of return on those costs.

The defect

- Paragraph 14.2.1 of the CUSC states that connection charges enable a Relevant Transmission Licensee to recover the costs involved in providing the assets to connect to the transmission system with a ‘reasonable rate of return’.
- This rate of return is currently set at:
    - 6% for RPI-linked assets; or
    - 7.5% for MEA-linked assets.
- The 6% value was originally equivalent to the price control pre-tax cost of capital.
- As the price control cost of capital has fallen, this is no longer the case.
- This proposal does not consider the appropriate difference between the return on RPI-linked and MEA-linked assets (which is currently set at 1.5 percentage points).

Why change?

- The long-standing rates of return are not currently linked to the cost of capital the Authority has determined for a Relevant Transmission Licensee in its price control settlement.
- As the cost of capital has declined the calculation of the charges has remained linked to a 6% return (and 7.5% for MEA-linked assets).
- Aligning the rate of return in the charging methodology to the pre-tax cost of capital in the price control settlement in force at any given time would ensure that the annual connection charges levied by a Relevant Transmission Licensee reflect Ofgem's latest view of a reasonable rate of return.
- This will result in a more cost reflective charges to Users.
- Failure to address this issue will result in a continued (and, based on current trends in the allowed cost of debt, growing) lack of cost reflectivity in the annual connection charge.

What needs to change?

- References to the rate of return in paragraph 14.3.21 of the CUSC (‘The Statement of the Connection Charging Methodology’) should be amended to define the RPI-linked rate of return as the pre-tax cost of capital determined in the relevant price control of a Relevant Transmission Licensee.
- We propose to retain the 1.5 percentage points delta for assets under the MEA revaluation method.
- The relevant value will update from year to year.
- Our proposed legal text will help to future-proof the drafting.
- It may be that a Relevant Transmission Licensee provides the system operator with the figure and publishes it such that Users can easily reference it (potential STC change).

How to derive the pre-tax cost of capital

- The pre-tax cost of capital calculation is proposed to be:

Pre-tax cost of capital = (1-gearing %) x pre-tax cost of equity + (gearing %) x cost of debt

Where:

Pre-tax cost of equity = post-tax cost of equity / (1 - corporation tax rate)

- Gearing and cost of debt can be sourced from the price control financial model (PCFM), as can the post-tax cost of equity.
- The product of this formula (plus 1.5% for MEA-linked assets) will replace the hardcoded 6% and 7.5% R_n term in the general formula in 14.3.21 of the CUSC.

Impact

- Aligning the rate of return to the pre-tax price control cost of capital will result in more cost reflective costs levied on the impacted Users.
- These more cost-reflective charges should ultimately be reflected in the charges seen by energy consumers.
- Ofgem's network access consultation ('Getting more out of our electricity networks by reforming access and forward-looking charging arrangements'), launched 23 July 2018, appears unlikely to consider the cost of capital used in calculating annual transmission connection charges.
- We do not believe this change will impact any existing or potential Significant Code Review (SCR) launched as part of the network access consultation, or any associated changes which may be led by industry as a result of the consultation.
- Ofgem's developing RIIO-2 proposals are related in determining what the cost of capital will be in the next price control.
- This proposal does not impact that process; instead it is drafted to ensure the enduring Connection Charging Methodology remains aligned with the price control.