Workgroup Consultation Response Proforma

CMP286 & CMP287: Improve TNUoS predictability through increased notice of the Target Revenue (CMP286) and inputs (CMP287) used in the TNUoS Tariff Setting Process

Industry parties are invited to respond to this consultation expressing their views and supplying the rationale for those views, particularly in respect of any specific questions detailed below.

Please send your responses to cusc.team@nationalgrideso.com by **5pm** on **9 May 2022**. Please note that any responses received after the deadline or sent to a different email address may not receive due consideration.

If you have any queries on the content of this consultation, please contact Paul Mullen paul.j.mullen@nationalgrideso.com or cusc.team@nationalgrideso.com

Respondent details	Please enter your details
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I wish my response to be:
(Please mark the relevant box) ☒Non-Confidential ☐Confidential

Note: A confidential response will be disclosed to the Authority in full but, unless agreed otherwise, will not be shared with the Panel or the industry and may therefore not influence the debate to the same extent as a non-confidential response.

For reference the Applicable CUSC (charging) Objectives are:

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;*

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 accordance with the STC) incurred by transmission licensees in their transmission businesses and which are compatible with standard licence condition C26 requirements of a connect and manage connection);*

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;*

d. *Compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or the Agency *; and*

e. *Promoting efficiency in the implementation and administration of the system charging methodology.*

**Objective (d) refers specifically to European Regulation 2009/714/EC. Reference to the Agency is to the Agency for the Cooperation of Energy Regulators (ACER).*

Please express your views in the right-hand side of the table below, including your rationale.

Standard Workgroup Consultation questions		
1	Do you believe that CMP286 and CMP287 Original proposal better facilitates the Applicable Objectives?	Mark the Objectives which you believe the Original solution better facilitates: Original ☐A ☐B ☐C ☐D ☐E **Objective A – 'Facilitates effective competition' – Negative** The workgroup are yet to fully understand whether all suppliers currently manage the price volatility risk cited in the defect via commercial innovation. Consequently, our view is that the modification proposal removes any incentive for suppliers to act more commercially in the interests of customers. **Objective B – 'Charges are cost reflective' – Negative** The proposal causes the revenue setting process between ESO and ET to revert to use of long-term forecast positions, as opposed to more accurate short-term forecast positions. Consequently our assessment is that the proposal reduces cost reflectivity of charges and is inconsistent with the intent of our licence Special Conditions. **Objective C – 'Takes account of developments in the transmission licensees' transmission businesses' – Negative** The RIIO-T2 Price Control inherently introduces more uncertainty for TOs given the greater reliance on uncertainty mechanisms along with the transfer of the TNUoS recovery cashflow risk from NGESO. This underlying 'allowable volatility' is carefully managed by the Onshore TOs, ESO and Ofgem, but would be greatly exacerbated by adopting the CMP286/7 proposal. **'Objective D – Compliance with any relevant legally binding decisions of the EU Commission' – Neutral/N/A** **Objective E – 'Promotes efficiency in the system charging methodology' - Negative** Additionally, CMP286/7 introduces the need for a new TO revenue true-up/reconciliation to correct forecast versus actual mismatches. This represents an entirely new form of volatility to the TNUoS tariff setting process for suppliers to mitigate. We also believe the transmission licence will also need to be modified to facilitate

		implementation of this modification (if approved), in addition to the extensive set of STCP changes already identified. Finally, we are also mindful of our licence obligation to use 'best endeavours' when setting charges to ensure that Recovered Revenue does not exceed Allowed Revenue and that any approval of this modification and/or subsequent licence modifications must be cognisant of the interaction with this obligation
2	Do you support the proposed implementation approach?	☐Yes ☒No
		We do not support the proposed implementation approach for the reasons noted in Q6. Additionally, given the necessary amendments required to transmission licence conditions (as mentioned above), financial instruments, and changes to the Annual Iteration Process related to this proposal (if it were approved), we would recommend any implementation to take effect for revenue setting for the first year of the T3 Price Control (i.e. Q3 2026). This would provide Ofgem and the transmission licensees time to suitably agree and implement licence, code and process changes - as well as avoiding unnecessary uncertainty for the remainder of the T2 Price Control.
3	Do you have any other comments?	The Onshore TO organisations are clear that CMP286/287 increases the risk to our businesses considerably, and even more so than the rejected CMP244 proposal. We believe that this proposal will actually more likely increase – not decrease – the volatility in setting TNUoS tariffs for all Users, and consequently drive additional unforeseen costs for end consumers. In addition, and as noted in our responses for Q1, Q5 and Q6, we see limited incentive for suppliers to innovate business practices to potentially reduce the need or extent of risk premia should this modification be approved. The presented evidence to support the defect and justify the proposed solution represents a subset of suppliers. There has been minimal conversation within the workgroup of potential alternative approaches, albeit we note Q7 seeks to understand this further.

Nevertheless, there is potentially a risk that intellectual property and/or competitive advantage protection within the supplier community prevents sharing of best practice which could minimise or mitigate the need for risk premia. If broader insights on this topic cannot be obtained, we are wary an automatic 'solution of last resort' approach (i.e. as per this proposal) could be taken, which in our view would actually be more detrimental than the baseline.

<u>Comparison of Distribution and Transmission charging regimes</u>

We note that the consultation references the 15 month charging notice that was implemented for the electricity distribution sector, inferring possible alignment at transmission as potential upside of this modification. However, Ofgem has already set out the key distinction between transmission and distribution that lead to acceptable deviations in approach:

> *Distribution network tariffs*
> CMP244 referred to a recent change to the electricity distribution tariff regime which altered the relevant industry code[13] such that DUoS charges are now set with 15 months' notice. The proposer noted that change to transmission charging for electricity would align the CUSC with the distribution charging regime and therefore reduce complexity. We have concluded that, whilst the two proposals are similar in intent, there are significant differences between the two types of networks. Compared to distribution revenue, transmission revenue is made up of many more diverse elements, creating significantly different forecasting risk. For example, the Distribution Network Owners (DNOs) do not have the option to bring forward large investment projects within a price control period as TOs do via the SWW mechanism. Indeed, assessment of these differences contributed to the reduction of the CMP244 proposed modification from 15 months' notice to 200 days' notice. In our view, this is a key difference which has led us to make a different decision in the transmission case.

https://www.nationalgrideso.com/document/7911/download

Ofgem has noted previously that a supplier response regarding the rejected CMP244 modification on non-domestic customers stated that setting inputs earlier would not provide a benefit because only a relatively small subset of customers actually fix energy rates in the time window that the additional notice would provide.

Ofgem quotes on short term revenue true-ups:
"We are significantly speeding up the cash-flow to companies once re-opener applications have been approved by forecasting revenues from UMs in the annual iteration process. This should reduce the time lag from approval of funding to companies receiving revenue from the current 2 years to less than a year."
Page 88:
https://www.ofgem.gov.uk/sites/default/files/docs/2020/12/final_determinations_-_core_document.pdf

		"Having considered stakeholder responses on re-openers, we acknowledge that the magnitude of re-openers and therefore the level of uncertainty in RIIO-2 is greater than in RIIO-1, which may benefit from a more flexible and agile form of revenue allowance. We note forecasting re-opener allowances will allow revenues to be more closely linked to output delivery, will further aid cost-reflectivity of allowances and will enable us to adapt allowances to any changes in network companies' circumstances without delay." Page 131: https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_-_finance_annex_revised_002.pdf
4	Do you wish to raise a Workgroup Consultation Alternative Request for the Workgroup to consider?	☐Yes ☒No
		Click or tap here to enter text.
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Specific Workgroup Consultation questions		
5	The Workgroup have concluded that if the CMP286 and CMP287 Original are approved, the risk premia that Suppliers price into contracts will be reduced. Do you agree with this conclusion? Please provide rationale for your response.	☐Yes ☒No Assessment on the application of risk premia has a range of estimates based on the provided analysis, however there are several key assumptions or details that are not included: - It is not explained how suppliers quantify the risk premia under the CMP scenarios; this should be provided to understand if the differences noted are what customers would face in practise. - There is also no mention of the number of suppliers which include a TNUoS specific risk, the apparent workgroup assumption is that they all do. - It is also clear that the average premia is not a weighted average value based on supplier size, so small suppliers would be equal weighting with large suppliers which could significantly skew the results.

		- The number of suppliers feeding in data is also not noted, raising concerns around the how representative reported risk premia could be of the wider market. Ultimately there is a lack of transparency in the risk premia data, which as stated, is due to the competitive environment suppliers operate in. In turn it affects the usability of the data as basis for setting out clear benefits of the modification proposals. We believe this RFI exercise does not provide full information as to what TNUoS-related risk premiums all industry participants charge, due to different parties' view of risk and their different ways of contracting. We understand that suppliers have different approaches to applying TNUoS-specific risk premiums to their prices, making it hard to quantify these and produce comparable data. As noted above, analysis of TO revenues for the proposer's chosen period of 2021/22 and 2022/23 shows that moving this risk to Onshore TOs simply moves the cost to customers around rather than being a clear benefit overall. Further, the additional cost to customers is set out clearly by Onshore TOs licence processes rather than the speculative benefits suggested in the risk premia analysis which cannot be confirmed. In summary, we believe there remains significant uncertainty in quantifying benefits relating to reduced risk premia, while the increased risk and downsides to Onshore TOs and customers are clear.
6	Does the CMP286 and CMP287 Original Proposal or any of the potential alternative solutions impact your business and/or end consumers. If so, how? *Confidential Information can be shared with Ofgem directly*	☒Yes ☐No **<u>TNUoS volatility in the context of CMP286/7</u>** This modification proposal seeks to remove a short-term price volatility issue for suppliers - although the data analysis presented in the consultation document is unclear whether this is an issue which impacts all suppliers - by imposing undue uncertainty and an increased cashflow risk on the Onshore TOs. In doing so it removes an incentive for suppliers to mitigate this issue, or worse, it undermines competition by giving some CUSC Parties an easier route to compete with fellow

		suppliers who may have already found methods to deal with this issue. We hope responses to the consultation will help verify the extent of this issue amongst the wider supplier community to help justify the CMP286/7 proposal. The Onshore TOs support any approach to minimise undue volatility in end consumer bills. However in the medium-to-long term it appears to us that the proposal will inadvertently introduce further adverse volatility, due to additional processes required to remediate the Onshore TOs actual Allowed Revenue. A clear unintended consequence of CMP286/7 is the introduction of ‘lumpy’ swings in revenues as true-ups flow through the ‘K’ and or ‘Adj’ terms in the Special Conditions of the transmission licence which set target revenue. Any ‘true-up’ fluctuations are not in the best interest of consumers, particularly as there is insufficient data currently to assess their potential materiality. In our view this undermines the overarching principle of charges being cost reflective and so contradicts with applicable objective B. In the Finance annex of Final Determinations, Ofgem set out to introduce forecast information within the Price Control Financial Model (PCFM), the benefit being highlighted as to ‘enable revenues to be more cost-reflective and should reduce the magnitude of subsequent true ups.’ This mod proposal not only introduces new volatility but also increases existing volatility which is contrary to Ofgem’s statement. The built-in forecasting risk as part of the RIIO-2 arrangements increases the further ahead in which TOs forecast (notwithstanding the licence requirement to forecast on a ‘best endeavours’ basis). Subsequent true-ups are likely to be bigger in magnitude when setting Allowed Revenue in RIIO-T2 than when setting charges based on the RIIO-T1 November published PCFM which relied on actual data rather than a forecast. If tariff timetables are extended to a 15 month period, not only does the forecasting risk increase for the initial setting of tariffs, but the period in which the volatility is flushed through the PCFM has extended also.

		This means that customers will be subject to more prolonged periods impacted by forecasting volatility, creating an entirely new defect as a result of this modification proposal. Additionally, a 15 month notice period for the Onshore TOs would mean that only 3 out of the 5 years within a price control period have a formal agreed financial framework in place. Year 1 and 2 would be particularly problematic (particularly considering requirements to forecast on a 'best endeavours' basis as already mentioned) and consequently puts the burden on Ofgem to accelerate its draft and final determinations process or provide licence derogations. The potentially sizable Allowed Revenue true-ups for the TOs driven by CMP286/287 - which would be trued-up at our nominal WACC – would inevitably be greater than any benefit from a reduced risk premia energy suppliers may make - in addition to the resultant tariff volatility and longer term uncertainty of tariffs. Referring to the proposer's analysis of Onshore TO's evolution of revenue forecasts for 2021/22 and 2022/23 - customers would have likely faced additional costs of £19m and £20m respectively when adjusting for the greater than £300m true up in each year that would have arisen when setting revenues +15 months ahead as opposed to the current arrangements. This true-up would also represent a large volatility in customers' bills as previously noted. Finally, the RIIO-2 licence allows for republication of Allowed Revenues for material changes with Ofgem's consent - after the Annual Iteration process concludes in November and prior to charges being published in the event there is a material change. Ofgem and the Onshore TOs spent significant resources to establish this principle and embed this process within the relevant licence instruments. If implemented, CMP286/7 undermines the Onshore TO's ability to do this. **<u>Outcomes of CMP244</u>** The CMP286/7 proposal shares a similar approach to the previously rejected CUSC modification proposal CMP44. In our view CMP286/7 has a far greater impact when compared to CMP244's proposal, which only sought to bring forward revenue setting timelines by 200 days as opposed to 15 months.

		Ofgem rejected this proposal with several of their reasons related to the additional risk on the TOs and subsequent uncertainty on customer bills. From a TO perspective, this rationale has not changed and in fact would be further exacerbated if the proposal is enacted under current TO arrangements. Here is a summary of key changes since the CMP244 rejection: • The implementation of RIIO-T2 brings more uncertainty for TOs given the increased reliance on uncertainty mechanisms to collect the correct revenues. By their nature these are not certain and would represent a potentially large cashflow risk if TOs cannot true these revenues up on the shorter timescales set out for RIIO-T2 (single year lag once values are known). Ofgem has directly recognised this increased level of uncertainty in RIIO-2 (see Ofgem quotes below). • From 2021/22 onwards demand risk has been transferred from the NGESO to the TOs. This was done based on the same quick true-up mechanism noted above, with Ofgem highlighting the short-term nature of the cashflow risk as part of the rationale for the risk transfer. CMP286/287 would mean TOs are doubly impacted compared to the rejected CMP244 proposal due to the increased allowed revenue risk noted above in addition to the new demand risk which also now increases cash flow volatility. This is particularly prevalent in current market conditions; there were unforeseen changes in the market in 20219/20 and 2020/21 as a result of COVID-19. The TOs would bear this risk and NGESO are not incentivised to optimise demand forecast accuracy. **Additional RIIO Price Control considerations for Onshore TOs** Despite forecasting using ‘best endeavours’, there are a number of items included in Allowed Revenue which are not within TO’s control which expose us to cashflow risks for which we are not remunerated.

		With a 15 month notice period, the time it takes for these elements of TO's revenue to true up for actuals takes 3 years (i.e. 2021/22 actuals not known until revenue setting in Dec-22 for 2024/25). <u>Inflation</u> Under the proposal, there will be a need to forecast inflation further in advance which is non-controllable and unpredictable. A high level analysis using forecast (RPIF) (on a t-2 basis) and actual (RPIA) inflation through periods 2016/17 to 2020/21 shows an average difference in RPI inflationary factor of 0.01. Applying this to TNUoS revenue results in sizable true-ups which would be collected on a 3 year lagged basis. For example, in 2020/21 charges, Onshore TO Allowed TNUoS Revenue was £2.4bn, equating to an inflationary true up of c.£240m. <u>Cost of Debt</u> Under current policy and licence conditions, cost of debt is set by Ofgem in November (based on iBoxx data up to 31st October data) as part of the Annual Iteration Process (AIP). This is used for the calculation of WACC and Allowed Revenue for the subsequent financial and charging year i.e. there is a 6 month lag between the data point and its use in charges. For example, the November 2022 AIP would use October 2022 cost of debt data, which is used for calculating 2023/24 Allowed Revenue & charges. This is noted in the Price Control Financial Handbook (PCFH) per the below. **Table 4.1 – time periods for calculation of iBoxx Trailing Average ($iBTA_t$) by Regulatory Year** Regulatory Year: 2022/23 — Time period for calculation: 01 November 2010 to 31 October 2021 Regulatory Year: 2023/24 — Time period for calculation: 01 November 2010 to 31 October 2022 Regulatory Year: 2024/25 — Time period for calculation: 01 November 2010 to 31 October 2023 Regulatory Year: 2025/26 — Time period for calculation: 01 November 2010 to 31 October 2024 However, under this CUSC proposal, for the same AIP (November 2022) the same index data would be used in the calculation of 2024/25 charges, creating a 12 month increase in the lag. This is a fundamental change in price control policy and introduces a new area of volatility into the revenue process which did not exist before. Furthermore, it undermines Ofgem's intent to 'enable revenues to be more cost-reflective and should reduce the magnitude of subsequent true ups'.

This change would also have extended ramifications on the Price Control Financial Handbook (PCFM).

Risk Free Rate

The same data principles above apply to setting the Risk Free Rate i.e:

Table 4.2 – time periods for calculation of risk-free rate by Regulatory Year

Regulatory Year	Time period for calculation
2022/23	01 October 2021 to 31 October 2021
2023/24	01 October 2022 to 31 October 2022
2024/25	01 October 2023 to 31 October 2023

This CUSC proposal again creates a new area of volatility into the revenue process.

Other changes

Regulatory and tax changes (for example the recent RIIO-2 CMA appeal and capital allowance changes) are not often foreseen significantly in advance and can take time to work through the relevant licence instruments. A 15 month notice period would increase this time, again resulting in larger true ups and swings in consumer bills.

Significant investment

Onshore TOs have a number of large investment projects (LOTI in RIIO-T2) and while all revenue would continue to be recovered for these projects the revenues would no longer be aligned to cash out flow in the way TOs have been assured as part of the RIIO-T2 arrangements. If revenues for such large projects were not adjusted close to when they are incurred, TOs could face a material shortfall compared to what they might otherwise have expected. Ofgem has previously noted they believe there would be greater benefits for consumers from allowing TO revenues to follow cash flows close to the time they are incurred. This is because the cashflow risk and financing costs could be greater than the benefit in terms of improving predictability.

In RIIO-2, TOs aren't funded for this extra risk and cashflow uncertainty, funding arrangements are based on a short-term revenue true-up assured by Ofgem as part of the RIIO-T2 arrangements (see Ofgem quotes below).

Onshore TO's 'best endeavours' obligation

Within Onshore TO's licences there is a 'best endeavours' obligation to ensure that 'when setting Network Charges' the revenue we recover does not exceed allowed revenue.

		The increased uncertainty in the levels of both Allowed Revenue and Recovered Revenue via extending the notice period for setting network charges to 15 months means that the challenge of meeting this RIIO-T2 obligation is increased. TOs are exposed to many variable impacting costs and performance, including but not limited to those mentioned above. Predicting these elements of revenue further in advance means TOs will have to take far more and significantly more costly steps than is currently the case. For example, once network charges have been set, the only recourse TOs have if it becomes clear that Allowed Revenue and Recovered Revenue are divergent would be to seek Ofgem's consent to re-set network charges at very short notice - in time to affect in-year revenues. This is likely to result in an additional burden for Ofgem in considering requests as well as more frequent, later, changes to network charges. Such a requirement could be triggered by any factor that affects Allowed Revenue or Recovered Revenue in a Regulatory Year for which network charges have already been set, including a change in forecast inflation or the forecast risk free rate, or any change in legislation that could result in additional expenditure. Moreover, it is not clear in the current drafting that "setting Network Charges" refers to an event that happens only once for each regulatory year. Setting network charges is an activity that TOs undertake at least once a year (and sometimes more often). The obligation could be read as requiring TOs to use 'best endeavours' to lobby Ofgem to waive the 15 months' notice requirement for setting network charges that have already been set every time they go through this process.
7	Are there other options which could enable Suppliers to mitigate the issues the proposer is seeking to address via this modification, which could avoid the need for code/licence changes (as applicable)? Please provide rationale for your response.	☒Yes ☐No The analysis provided by the modification proposer is based around the TO's revenue forecasts for the beginning of the T2 price control. These were forecasts at a point in time where arrangements and Ofgem decisions around the price control were unknown.

		The analysis presented by the proposer therefore depicts the volatile reality in bringing in an earlier tariff timetable due to the forecast and unknown nature of numbers the TOs would be required to include within tariffs. A possible alternative to the proposal to reduce TO revenue forecasting volatility would be in the strengthening of the RIIO Price Control process with Ofgem - namely more certainty during business plan submissions and draft and final determinations - leading to a better ability to forecast revenue earlier in the process. We appreciate that such an approach would take significant effort and/or be a major deviation from current process for Ofgem and the Onshore TOs, which could be disproportionate in relation to the impact of the underlying issue.
8	Do you have any additional analysis that supports or counters the benefits of CMP286 and CMP287? Are you content to share this directly with Ofgem?	☒Yes ☐No This is available to Ofgem/the workgroup on request.