Making a positive difference for energy consumers

Modification proposal:	**Connection and Use of System Code (CUSC) CMP244: 'Set final TNUoS tariffs at least 15 months ahead of each charging year' and CMP256: 'Potential consequential changes to the CUSC as a result of CMP244'**
Decision:	The Authority[1] has decided to reject[2] these modifications[3]
Target audience:	National Grid Electricity Transmission plc (NGET), Parties to the CUSC and other interested parties
Date of publication:	15 July 2016 — Implementation Date: N/A

Background

The costs of the electricity transmission system are recovered from generators, suppliers and other users of the transmission system through Transmission Network Use of System (TNUoS) charges. These are calculated annually by National Grid Electricity Transmission (NGET)[4] and are published at the end of January each year for the charging year that starts on 1 April later the same calendar year (two months' notice).

CUSC modification proposal CMP244 seeks to increase the length of the notice period for TNUoS tariffs from the current two months to a suggested period of 200 calendar days (approximately 6½ months before the relevant 1 April). The proposed notice period was originally 15 months but the proposer subsequently reduced it. CMP244 proposes changes to Section 14 of the CUSC (Charging Methodologies).

CMP256 seeks to introduce consequential changes to Sections 3 (Use of System) and 11 (Interpretation and Definitions) of the CUSC as a result of charging modification CMP244.

The modification proposal

CMP244 was raised by EDF Energy (the 'proposer') and submitted to the CUSC Modifications Panel (the 'Panel') for its consideration in May 2015. The perceived defect identified by the proposer was that the current publication of TNUoS charges two months ahead of the start of each charging year creates uncertainty that is difficult for suppliers (or business customers on pass-through TNUoS contracts) to manage effectively. The proposer believes that this uncertainty means that suppliers include a risk premium when setting prices for longer term fixed contracts, leading to an increase in prices for end consumers. The proposer considers that this risk would be better managed centrally by NGET as System Operator due to its lower cost of capital. The proposer also noted that this uncertainty may be more difficult for small suppliers to manage, and hence could be adversely affecting competition.

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] 'Change' and 'modification' are used interchangeably in this document.
[4] Throughout this letter, National Grid is referred to in relation to its duties to calculate TNUoS tariffs.

The proposer referred to a recent change to the electricity distribution tariff regime which altered the relevant industry code[5] such that Distribution Use of System (DUoS) charges are now set with 15 months' notice. The proposer considered that changing the notice period for TNUoS charges would align the CUSC with the distribution charging regime and would reduce complexity.

As part of the workgroup discussions assessing CMP244, it was recognised that, if CMP244 is approved by the Authority, consequential changes to Sections 3 and 11 of the CUSC would be required as these sections refer to TNUoS-related timescales. As non-charging CUSC modifications are assessed against different CUSC objectives, these consequential changes are dealt with through a separate code modification. CMP256 was therefore raised by EDF Energy and submitted to the Panel for its consideration in November 2015.

Both modifications were assessed jointly by the same workgroup, as agreed by the Panel. It should be noted that, without approval of CMP244, CMP256 would fall away.

The workgroup considered the costs, benefits, risks and issues arising from CMP244. In order to set TNUoS tariffs, NGET requires data on two main elements: network revenues which are due to the various transmission owners, and the "charging base", ie the various users who pay for the network. The workgroup's analysis showed that a 15 month notice period would substantially increase the number of parameters which would need to be forecast compared to current arrangements, materially increasing the risk of forecasting error.

In light of the analysis, the workgroup considered alternative lengths for the notice period. As a result, the proposer considered that a TNUoS tariff notice period of 200 days would be a better solution than the initially proposed 15 months because more actual data (as opposed to forecasts) would be available, and for those parameters which needed to be forecast, the shorter period would reduce the forecast error risk.

No alternative modifications were raised through workgroup assessment for either CMP244 or CMP256. The majority of workgroup members voted in favour of both proposals based on their view that the proposals better facilitate competition. The workgroup's detailed discussions are described in the Final Modification Report (FMR).[6]

CUSC Panel[7] recommendation

At its meeting on 27 May 2016, the Panel agreed by majority that the CMP244 and CMP256 solutions as proposed better facilitate their respective CUSC objectives compared to the existing baseline, in particular, the objective of facilitating competition. The majority of the Panel felt that the proposals were neutral on all the other objectives.

The views of Panel members are set out in the FMR.

---

[5] Distribution Connection and Use of System Agreement (DCUSA) change proposal DCP178 at: https://www.dcusa.co.uk/Lists/Change%20Proposal%20Register/DispForm.aspx?ID=143&Source=https%3A%2F%2Fwww%2Edcusa%2Eco%2Euk%2FSitePages%2FActivities%2FChange%2DProposal%2DRegister%2DArchive%5F100%5Frecords%2Easpx&ContentTypeId=0x0100684A1DE09E1F9740A444434CF581D435
[6] CUSC modification proposals, modification reports and representations can be viewed on the NGET website at: http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/Current/
[7] The CUSC Panel is established and constituted from time to time pursuant to and in accordance with the section 8 of the CUSC.

Our decision

We have considered the issues raised by the modification proposals and the FMR dated 9 June 2016. We have considered and taken into account the responses to the Code Administrator consultation on the modification proposals which are attached to the FMR.[8]

We have concluded that there is insufficient evidence that the implementation of the modification proposals would better facilitate the achievement of the CUSC charging objectives (in the case of CMP244), and the applicable CUSC objectives (in the case of CMP256), for the reasons set out below. We have also concluded that directing that the modifications be made would **not** be consistent with the Authority's principal objective and statutory duties.[9]

The proposer considered that CMP244 would enable suppliers to reduce the risk premiums they add to their electricity prices, resulting in lower prices to some of their non-domestic customers. The proposer also considered that CMP244 would improve competition amongst suppliers. We consider that the FMR has not presented conclusive evidence for these arguments.

The proposer considered that it would be more efficient for NGET to bear the TNUoS forecasting risk than suppliers because NGET's cost of capital is lower. We consider that, while there are merits to this argument, the forecasting risk would not only be transferred to NGET but also to the other transmission owners (TOs) who would have to bear additional and new risks. We consider the impacts of these forecasting risks to be uncertain and potentially significant. CMP244 could lead to some instances where recovery for Strategic Wider Works (SWW) is delayed. This would subject TOs to greater cash flow risk and financing costs. We consider that there is insufficient evidence that these impacts are in the interests of consumers.

In summary, we consider that there is significant uncertainty about the potential benefits of CMP244 and CMP256 and that CMP244 and CMP256 would create potentially significant new and additional risks, and increased costs to consumers. We have set out our detailed reasoning below.

Reasons for our decision

CUSC Objectives

We have considered the views of the Panel and respondents to the industry consultation. We set out below our views on the relevant CUSC objectives that we consider are impacted by these modification proposals. In respect of all other CUSC objectives (charging and non-charging), we consider the proposals are neutral/have no impact.

Charging objective (a) for CMP244 "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" and

[8] CUSC modification proposals, modification reports and representations can be viewed on the NGET website at: http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/Current/
[9] The Authority's statutory duties are wider than the matters which the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

non-charging objective (b) for CMP256 "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"

The proposer argued that larger suppliers may have better capabilities to forecast TNUoS than smaller ones. This may result in smaller suppliers having to add larger risk premiums. A longer notice period would reduce TNUoS uncertainty for all. This would level the playing field between larger and smaller suppliers and improve competition.

We accept the argument has merits in principle but the FMR has not quantified this benefit nor set out other strong evidence for it. On balance, we consider that a clear case has not been made that CMP244 and CMP256 would better facilitate the achievement of the relevant objectives. We therefore consider the impact on this objective to be neutral.

Charging objective (b) for CMP 244 "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 unclear 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)"

Some stakeholders argued that CMP244 would reduce cost reflectivity because setting charges further in advance would mean that forecasts used to set charges would be less accurate. To the extent that any inaccuracies, eg in respect of the closure of existing generation, would affect the locational signal, we agree with this argument. However, given the long-term nature of the investment signal given by TNUoS, we do not consider that this effect is significant. We also note that increased over/under-recovery is likely to have a negative impact on cost reflectivity. We therefore consider that CMP244 is marginally negative against this objective.

Charging objective (d) for CMP244 "compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or ACER" and non-charging objective (c) for CMP256 "compliance with the Electricity Regulation and any relevant legally binding decision of the European Commission and/or ACER"

We consider CMP244 is neutral against this objective. Under EU Regulation EC 838/2010, the average transmission charge for GB generation should be within the range €0-€2.50/MWh. To help mitigate the risk of exceeding an average charge of €2.5/MWh due to forecast error, NGET uses an error margin. A longer TNUoS tariff notice period will, on average, increase the size of forecast errors. NGET would, however, be able to respond to this by increasing the size of the error margin that it uses. We therefore do not consider that approving this modification would affect compliance with EU regulation EC 838/2010.[10]

Overall view of CUSC Objectives

We have concluded that there is insufficient evidence to conclude that the implementation of the modification proposals would better facilitate the achievement of

---

[10] We note that another relevant CUSC proposal in this context, CMP251"Removing the error margin in the cap on total TNUoS recovered by generation and introducing a new charging element to TNUoS to ensure compliance with European Commission Regulation 838/2010", is due to come to us for decision later this year.

the CUSC charging objectives (in the case of CMP244), and the applicable CUSC objectives (in the case of CMP256).

We also consider that approving the proposal would be inconsistent with our statutory duties and our principal objective of protecting the interests of existing and future consumers. We have set out our detailed reasoning below.

Impacts on consumers

Supplier risk premium
The key advantage put forward for CMP244 is that it would reduce the risk premiums that suppliers add to their electricity prices for non-domestic, fixed-price, fixed-term contracts, and this would result in lower costs to non-domestic customers with these types of contracts. The workgroup explored various approaches to quantifying this benefit in terms of an overall reduction of risk premiums. However, industry was unable to provide the necessary data to the workgroup due to its commercially sensitive nature, and therefore, the workgroup could only discuss this benefit qualitatively.

The workgroup put forward the possibility of Ofgem holding a data gathering exercise on supplier risk premiums instead. We carefully considered the pros and cons of undertaking such an exercise. The workgroup had acknowledged that this would 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. Therefore, we do not believe that such an exercise would have provided us with any better information than that already provided to the workgroup.

Business planning for non-domestic customers
Suppliers considered that providing longer term tariff certainty would help non-domestic customers with their business planning. One large business user responded to the industry consultations to confirm this was the case. One supplier considered that CMP244 does 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.

Overall, we consider that the potential benefits of CMP244 would apply to a limited subset of business customers, and that it has not been possible to assess the order of magnitude of these benefits.

TNUoS forecasting
The workgroup discussed what impact extending the notice period would have on the accuracy of TNUoS tariffs. In order to set tariffs annually, NGET has to use a number of parameters, some of which are actuals and others which are forecast. An extension of the TNUoS notice period would mean that more parameters would need to be forecast than is currently the case. This could mean that the magnitude of over/under-recovery of revenue could rise, increasing tariff volatility from year to year. In turn, this could result in a rise in longer term uncertainty of tariffs (a point particularly made by the Scottish transmission owners (TOs)).

We indicated to NGET and the workgroup that, under CMP244, NGET may need to forecast OFTO and interconnector cap and floor revenues (for reasons explained below). We consider that NGET would be better placed to bear these additional forecasting risks than the OFTOs and cap and floor interconnectors due to NGET having a lower cost of capital. NGET argued that these additional forecasting risks (which also apply to other elements such as innovation funding) are likely to significantly increase over time as the offshore and interconnector sector continues to expand. This would materially increase the likelihood of NGET breaching the scheme under the current price control[11] which incentivises it to forecast accurately, and would penalise it as a result. Any penalties would be an additional cost, ultimately borne by consumers.

A way to mitigate additional forecasting risks could be to amend the forecasting incentive scheme. Such a change would involve amending the current eight-year price control. We have considered this. We believe that in the medium to long term, as new OFTOs and cap and floor interconnectors come online, there are uncertainties which make it very difficult to assess forecasting risks and establish an appropriate fixed level for the eight-year incentive scheme.

Scottish transmission owners
We noted the comments of the two Scottish TOs. The TOs need to submit their revenue forecasts by 1 November each year as input to NGET's TNUoS tariff setting exercise, and submit final figures by 25 January. If CMP244 is approved, the TOs would have to do so in advance of the 200-day notice period. They believe this would result in greater forecasting errors and could mean that the magnitude of over/under-recovery of TO revenue could rise, increasing tariff volatility. In turn, there could be longer term uncertainty of tariffs.

Strategic Wider Works (SWW) cost recovery
As noted under CUSC charging objective (b), under CMP244, all revenue would continue to be recovered. However, in some cases, recovery could be a year later than is currently the case. We consider that such delays to recovery of revenue for SWW projects would significantly impact all TOs since this can make up a material portion of the TOs' asset base, particularly in Scotland. 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. We think there could be greater benefits for consumers from allowing the company's revenues to follow cash flows close to the time they are incurred. This is because the cash flow risk and financing costs could be greater than the benefit in terms of improving predictability.[12]

Other issues we considered

Offshore transmission revenue forecasting
Offshore transmission owners (OFTOs) commented that the proposal had not taken OFTO business model characteristics into account. Like onshore TOs, OFTOs currently provide revenue forecasts by 1 November each year as input to NGET's TNUoS tariff setting exercise, and submit final figures by 25 January. The timing of this ensures that OFTOs have a high degree of certainty that the correct revenue will be recovered. This is because the calendar year is used for the availability incentive, and inflation is calculated over the calendar year or September/September.

One option for implementing CMP244 would be for OFTOs to submit their revenue forecast in advance of the 200-day notice period. This would subject the OFTOs to significantly increased revenue forecasting risks (particularly with regard to the

[11] Details of the incentive scheme are set out in the FMR.
[12] We set out this point in our decision on the Caithness Moray Strategic Wider Works project: https://www.ofgem.gov.uk/publications-and-updates/decision-our-assessment-caithness-moray-transmission-project

availability incentive), with each individual OFTO facing the possibility that actual revenues could vary by up to 15% based on availability performance, plus other potential revenue changes for particular pass through items.

Interconnector revenue forecasting
Similar to OFTOs, interconnector developers were not supportive of the proposal on the basis that the impacts on cap and floor interconnectors have not been adequately assessed. They also highlighted that an increase in the current two-month notice period to 200 days would expose them to a significant cash flow risk, incurring additional financing costs.

An alternative to requiring OFTOs/interconnector owners to forecast further in advance is for NGET to take on that risk (see above).

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.

Conclusion

We consider that there is significant uncertainty about the potential benefits of CMP244 and CMP256 in terms of any reduction of risk premiums charged to a subset of non-domestic customers, and in terms of competitiveness between suppliers. In this context, we have been unable to justify the potential for risk relating to cash flows and financing costs on the TOs and NGET, and, in the long run, on the consumer, resulting from CMP244 and CMP256.

Decision Notice

In accordance with Standard Condition C10(1) of NGET's Transmission Licence, the Authority hereby directs that modification proposals CMP244 *'Set final TNUoS tariffs at least 15 months ahead of each charging year'* and CMP256 *'Potential consequential changes to the CUSC as a result of CMP244'* not be made.

Yours sincerely,

Frances Warburton
Partner, Energy Systems
Signed on behalf of the Authority and authorised for that purpose

[13] DCP178 – see footnote 5.