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Dear Stuart,

Thank you for the opportunity to provide evidence to Ofgem's review of the transmission charging arrangements. Project TransmiT is a welcome initiative by Ofgem. We have provided our evidence in the attached note, which sets out why the existing electricity transmission charging methodology is no longer fit for purpose and puts forward an alternative arrangement for charging. We have taken the opportunity to highlight the main points of the note here.

In order to facilitate the timely move to a low carbon energy sector, we believe that the focus of the review should be on electricity transmission and in particular the charging arrangements. We believe that there is strong evidence to suggest that the Government's and Ofgem's objectives in relation to climate change and indeed renewables, are in danger of not being achieved as a result of the current charging methodology. Our response therefore focuses on the electricity transmission charging arrangements.

In our view, this review is a one-off chance to deliver against renewable and security of supply targets. As such, the review needs to come to a speedy conclusion. This suggests that the solution needs to be one that is simple and be guaranteed to bring forward increased renewable deployment. It would be unacceptable to gamble on the chance of implementing another complex methodology (e.g. another version of incremental cost related pricing (ICRP) or one that includes time of use charges) that will take time to develop and implement, but, be no more certain than the existing ICRP methodology in bringing forward renewables.

It is clear from the work by carried out by Ofgem on Project Discovery, that a Green Transition or Green Stimulus package will best meet security of supply and renewable ambitions at least cost to customers. However, the current arrangements for charging

for access to the GB transmission network do not encourage investment in new renewable generating capacity. This has been most recently highlighted on Orkney where the Fairwind project has been cancelled due to the high transmission charges and on the Western Isles, where, due to the lack of financial underwriting from electricity generators (attributed to the level of transmission charges) relating to the link from the Western Isles to the mainland, the investment in the cable is not going ahead.

The ICRP model used by National Grid in setting Transmission Network Use of System (TNUoS) tariffs is complex, and results in TNUoS tariffs that are extreme, volatile, unpredictable and not cost-reflective. Further they are distorting retail competition, are having an adverse impact on security of supply and are at odds with the creation of a wider European market. The ICRP model has been showing ever increasing signs of stress as renewable development has gathered pace, e.g. in relation to the Scottish Islands and very dramatically in relation to the “bootstraps”. Indeed, if National Grid believe that their charging model remains robust, that the charges it produces are cost reflective and are providing the correct signals for where new generation should connect, then they should not be going ahead with their investment in the “bootstraps”.

It would be a failure of the review if the same deficiencies remained in any new methodology and set charges at similar levels for the Scottish Islands and the bootstraps.

A further weakness been highlighted by Ofgem’s recent decision to remove charges from the Interconnectors. This is likely to result in perverse outcomes that we made clear in our response to National Grid’s consultation. However, should this review conclude that Interconnectors can continue to be treated differently from all other Users with respect to the methodology for transmission charging in GB, we believe that such a decision would be discriminatory and challengeable.

It should also be noted that at implementation, the original ICRP model for E&W considered the sensitivity of the model for various generation and demand scenarios. The most extreme result under the scenarios was an increase of £3.30/kW. The conclusion drawn was that the model was robust to the input assumptions and scenarios tested. Given the level of changes being seen now from the model, it is clear that the current ICRP model fails to meet those original standards on an ongoing year-to-year basis and more so when large-scale additions to the network to accommodate new renewables are considered, e.g. the bootstraps. If brought forward for consideration today, the ICRP model would be rejected.

The existing methodology focuses on an attempt at cost-reflective pricing, yet it can be shown to fail to achieve this. It should also be recognised that cost-reflectivity is itself only an objective to be met where it is “reasonably practicable”. This blind adherence to cost-reflectivity needs to be abandoned. Cost-reflectivity needs to be seen as a means to an end, rather than an aim. The end should be efficient investment in infrastructure to allow the Government to meet its legally binding climate change targets. The methodology for charging for use of system needs to be considered in the wider context of meeting renewable and climate change goals.

We believe that the renewable and climate change goals can be achieved through the implementation of a simple framework consisting of:

- a uniform commodity charge for the use of wider shared transmission assets along with a locational signal provided through a combination of
 - i) a local connection charge and
 - ii) potentially a locational transmission loss factor
- a fairer and more proportionate User Commitment

Whilst our views on the failings of the current charging methodology apply equally to demand-side tariffs, the impact on competition in supply is less acute given that all suppliers face the same transmission charge for any individual customer and the main driver for change to the methodology is moving to a low carbon generation sector. So, whilst in principle we have no objection to the framework proposed here being applied to both generation and demand across GB, it is put forward and described here in its application to generator charges only.

We believe our proposed framework will have the benefits of being:

- Simple;
- Quick to implement;
- Support Government objectives;
- Predictable;
- Non-discriminatory;
- More cost reflective; and
- Be a positive step towards a wider European market.

The use of a uniform commodity charge is proposed here as we believe that there is strong evidence that the current locationally varying element of the tariff is no more cost-reflective than a uniform tariff approach. In considering the specific issue of the cost-reflectivity of the current TNUoS tariff, the correlation between TNUoS (specifically, the locational element) and transmission investment was examined in detail as part of the Transmission Access Review. The conclusion reached was that TNUoS is not a good proxy for network investment.

In addition, where charges cannot be shown to be doing what they are meant to, and are going against the public good by adversely impacting on new renewable generation and security of supply, a move to a uniform commodity charge that will allow the Government to better meet its renewable and climate change targets can be considered a public policy benefit.

Consequently, we believe that replacing a charge that is not cost-reflective with an average charge is a relative improvement, and the case is compelling when the many other benefits of a uniform tariff are also taken into account. An allocation of costs through a uniform commodity charge that is right on average is preferable to an allocation that purports to be cost-reflective yet is demonstrably wrong for everyone.

The use of a uniform commodity charge can also rely on a number of precedents within the electricity market arrangements, justified as achieving climate change and renewable objectives, or bringing an economic or societal benefit, e.g. BSUoS

charging and frequency response costs. It can also be shown to be consistent with the majority of schemes across Europe.

The framework set out here, rather than falling into the trap of inefficient and inaccurate allocation of costs, seeks instead to allocate these costs on an average basis. It also moves away from the blind adherence to cost-reflectivity and instead seeks to meet the wider need of renewable and climate change goals.

In order to remedy the significant barrier that the current arrangements for Final Sums Liabilities (FSL) place in front of developers, the framework we propose here also puts forward reform of the arrangements and changes to the User Commitment requirements.

Whilst not within the scope of this review, the proposals for zonal (locational) transmission losses under the BSC would only add to the punitive nature of transmission charges. Such a doubling of the locational penalty would be both discriminatory and disproportionate. We believe that the implementation of any new transmission losses scheme needs to be considered as part of this review and that the decision on BSC Modification P229 should not be made until the review has concluded. This view aligns with Ofgem's view of 1999¹, that it may be inefficient to expose participants to both sets of locational charges. We will continue to resist the imposition of a zonal losses scheme in combination with the existing ICRP methodology. However, the framework proposed here could sit comfortably with a zonal transmission losses scheme.

Finally, we note that the original ICRP methodology was phased in over three years recognising that users may find it difficult to adjust to a change in their cost for use of system overnight. Any fundamental shift in the methodology will similarly need to consider the implementation timetable.

I hope that you find our response helpful. If you would like to discuss any of the above in more detail, please do not hesitate to contact me.

Yours sincerely,

Robert Hackland
Regulation Manager

¹ Extract from: *NGC System Operator Incentives, Transmission Access and Losses Under NETA: A Consultation Document*; Ofgem, December 1999.

Introducing the marginal pricing of losses will result in signals being provided to participants of the short-run marginal costs of electricity transmission. Currently, the TNUoS charges provide signals as to the long-run marginal costs of electricity transmission. Both the proposed losses scheme and the TNUoS charges provide locational signals and, given the interactions between short run and long run marginal costs, it may inefficient to expose participants to both sets of locational marginal costs charges. Hence, it may be appropriate, when introducing a new transmission losses regime to revisit the method of calculating TNUoS charges so that they are exposed to a consistent set of short and long-run signals and charges. The introduction of a new transmission access and pricing regime will, in any case, require TNUoS charges to be revisited and we believe that the impact of marginal losses should be considered at the same time.

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