

Modification proposal:	<b>Connection and Use of System Code (CUSC) modification 224 (CMP224): Cap on the total TNUoS target revenue to be recovered from Generation Users</b>		
Decision:	The Authority directs that the original proposal be made <sup>1</sup>		
Target audience:	National Grid Electricity Transmission plc (NGET), all transmission system users, parties to the CUSC and all other interested parties		
Date of publication:	8 October 2014	Implementation Date:	22 October 2014

## Background to the modification

CMP224 proposes to limit the total costs recovered from generators in Great Britain (GB) through Transmission Network Use of System (TNUoS) charges in a given year. This is to comply with European Commission Regulation (EU) No. 838/2010 (the Regulation)<sup>2</sup>, which restricts the average transmission charges paid by generators in European Union (EU) member states. If implemented, CMP224 will reduce TNUoS charges for generators putting electricity onto the network and increase TNUoS charges for users taking electricity from the network (demand users).

The total costs that transmission network owners are allowed to recover each year via TNUoS charges are set by us using the price control process.<sup>3</sup> The proportion of these costs recovered from generation (G) and demand (D) network users is determined by the 'G:D split'. This is currently set at '27:73', ie 27 per cent of transmission network costs are recovered from generators and 73 per cent from demand network users.

TNUoS charges comprise a 'locational element' and a 'residual element'. The locational element reflects the different costs that network users impose on the network depending on where they choose to locate. The residual element is set to recover the remaining costs allocated to generation and demand through the G:D split after subtracting revenue recovered via locational charges. For generators, the locational element of the charge is made up of a zonal charge that recovers the costs of the main integrated transmission system (MITS), and a local charge that recovers the costs of the assets required to connect the generator to the MITS. For demand network users, the locational element is a wider zonal charge only.

The Regulation sets ranges of allowable average transmission charges paid by electricity generators in the EU. For GB, the allowable range is €0-2.5/MWh. The average charge for each member state is the total transmission charges collected from generators in that member state in a given year divided by the total output of those generators in that year. Charges for electricity transmission losses, ancillary services and charges for physical assets required for connection to the system or the upgrade of the connection are excluded from this calculation, and so are not restricted by the Regulation.

Based on current forecasts and the current G:D split of 27:73, average transmission charges for generators in Great Britain are expected to exceed the €2.5/MWh upper limit at some point over the five years from 2015/16 to 2020/21. The date when this may happen depends largely on the interpretation of the Regulation as discussed below.

## The proposals

National Grid Electricity Transmission (NGET) raised CMP224 in September 2013 with the aim of adjusting the G:D split each year to mitigate the potential risk of exceeding the upper limit on average generator charges set by the Regulation. CMP224 proposes making changes to the methodology so that the proportion of revenue recovered from generation is set each year to the lower of either:

<sup>1</sup> This document is notice of the reasons for this decision pursuant to section 49A of the Electricity Act 1989.

<sup>2</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:250:0005:0011:EN:PDF>

<sup>3</sup> <https://www.ofgem.gov.uk/ofgem-publications/64003/pricecontrolexplainedmarch13web.pdf>

- the current level of 27% or
- the maximum amount that results in the average transmission charge for GB not exceeding the upper limit set by the Regulation.

The remaining allowed revenue will be recovered from demand users of the electricity transmission system.

The proposals would set the G:D split ahead of the relevant charging year based on forecasts of the relevant variables.<sup>4</sup> So there is a risk that charges exceed the upper limit of the Regulation because of forecast error. To mitigate this risk, the proposals include an 'error margin', ie the G:D split would be set with the target of an average transmission charge for generation that is below (rather than equal to) the upper limit allowed by the Regulation. The error margin would be set by NGET each year based on its historical forecast.

The industry workgroup assessing CMP224 developed four proposals: the original proposal and three Workgroup Alternative CUSC Modifications (WACMs) - WACM1, WACM2 and WACM3. The four proposals vary based on:

- how they interpret paragraph 2(1) in Annex Part B of the Regulation, which excludes '*charges in respect of physical assets required for connection to the system*' from the calculation of a member state's average electricity transmission charge
- when the G:D split is set, ie the period of time between when it is set and the start of the relevant charging year (for longer lead times there is a greater error margin).

### Interpreting the Regulation

The workgroup considered several potential interpretations, two of which were taken forward and were included in the proposals submitted to us for decision:

1. '**Strict Interpretation**' – only connection charges are excluded from the calculation of the average charge.
2. '**Broad Interpretation**' – connection charges and local charges for radial circuits that supply generators only (Generation Only Spurs) are excluded from the calculation of the average charge.

### Lead time for setting the G:D split

The proposals also vary based on a 'lead time' between the setting of the G:D split and the start of the relevant charging year (1 April). The proposals suggest either **2 months** or **12 months**.

A longer lead time would make it easier for network users to predict future charges, but also means that the accuracy of forecasts used to set the G:D split is affected as it tends to be easier to make shorter term forecasts. Less accurate forecasts would increase the risk of exceeding the upper limit of the Regulation because of forecast error. To mitigate this increased risk, the error margin would be larger for options that use the longer 12-month lead time. Based on current data, NGET estimates that the error margin for 2015/16 would be set at 7 per cent for options that use a two-month lead time and 14 per cent for a 12-month lead time.

The four proposals submitted for our decision comprise different combinations of the factors discussed above, as shown in **Figure 1** below. We also had the option to reject all the proposals and maintain the current charging arrangements.

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<sup>4</sup> The G:D split will be set based on NGET's forecasts of demand, allowed revenue, connected generation capacity and the Pound Euro exchange rate.

**Figure 1 – the proposals**

	<b>Two-month lead time</b> (smaller error margin)	<b>12-month lead time</b> (larger error margin)
<b>Strict Interpretation:</b>	Original proposal	WACM1
<b>Broad Interpretation:</b>	WACM2	WACM3

### **CUSC Panel recommendation**

The CUSC Panel voted on CMP224 at its meeting on 25 April 2014. A majority of Panel members voted that both the original and WACM1 better facilitate the relevant CUSC charging objectives when compared to the current arrangements. The Panel also voted that, overall, WACM1 best facilitates the relevant CUSC charging objectives when compared to the current arrangements. The Panel members’ full views are set out in the Final Modification Report (FMR).<sup>5</sup>

### **Our consultation**

On 14 July 2014, we published a minded-to consultation (our July consultation) setting out our minded-to position on the proposals, and seeking further views from industry.<sup>6</sup> Our minded-to position was to approve the original proposal. This was based on our initial view that:

- all options proposed under CMP224 better facilitate the relevant CUSC charging objectives compared to the CUSC baseline
- WACM1 better achieves the relevant CUSC charging objectives compared with the other options, but that
- WACM1 is likely to have a greater negative impact on consumers compared with the original proposal.

Of the twelve responses received, two were in favour of our minded-to position and ten were against. The majority of respondents against our minded-to position supported the approval of CMP224, but preferred WACM1 to the original proposal. A summary of the responses is in Appendix 1 to this letter and the full responses are published on our website. Our views on the evidence and arguments raised by respondents are in the following sections and in Appendix 1.

### **Our decision**

We have considered the issues raised by the original and WACM proposals under CMP224 set out in the FMR. We have also considered the responses to the Code Administrator consultation which are included in the FMR and the responses to our July consultation. We still consider that:

- all options proposed under CMP224 better achieve the relevant CUSC charging objectives compared to the CUSC baseline
- WACM1 better achieves the relevant CUSC charging objectives compared with the other options, but that
- WACM1 is likely to have more of a negative impact on consumers compared to the original proposal.

We therefore **direct that the original proposal is implemented**. This is in line with our principal objective to protect the interests of current and future energy consumers. It is also in

<sup>5</sup> <http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP224/>

<sup>6</sup> <https://www.ofgem.gov.uk/publications-and-updates/consultation-connection-and-use-system-code-modification-proposal-224>

line with our statutory duties that require our decision to result in charges that comply with the range of allowable transmission charges for GB set out in Annex Part B of the Regulation.

### **Reasons for our decision**

We set out below our views on the options submitted to us under CMP224 against the relevant CUSC charging objectives, our principal objective and statutory duties.

#### Assessment against the relevant CUSC charging objectives

*Objective (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'*

The options presented to us would affect competition in two ways:

- by bringing transmission charges for generation more closely into line with generators in other EU member states
- by affecting the predictability of transmission charges for generators and suppliers.

Bringing transmission charges for GB generators more closely into line with those of their EU counterparts should reduce market distortions, which, in principle, should result in more efficient competition between GB and other EU member states and improved competition in the generation of electricity compared with the current baseline. WACM1 would most closely align charges in GB with those in other EU member states and, therefore, performs best in this respect compared to the other proposals and the current baseline. The original proposal performs next best in this respect followed by WACM3, WACM2 and the current baseline.

Changing the G:D split from year to year would reduce the predictability of transmission charges for suppliers and generators compared with the current baseline. This is likely to increase risk for both generators and suppliers to some extent which may negatively impact competition in the supply and generation of electricity. We would expect this negative impact to be greater for options that use the strict interpretation of the Regulation (the original proposal and WACM1) as the transfer of costs from generation to demand is likely to start in the 2015/16 charging year. Network users would therefore have relatively little advanced warning of the changes in the G:D split, making charges more difficult to predict. In future, this effect would be mitigated to some extent by the longer 12-month lead time under WACM1 and WACM3.

We note the limited evidence presented to us in the FMR and consultation responses on the impact of reduced predictability of charges. Based on the evidence available, we consider that the effects on competition of better aligning charges for GB generators with charges in other EU member states are likely to be more significant than the increased risk associated with changing the G:D split from year to year. Taking this into account, we consider that all the proposals submitted to us better facilitate this objective compared to the current baseline and that WACM1 best achieves this objective followed by the original proposal, WACM2 and WACM3.

*Objective (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 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)'*

The proposals would affect the residual charge for generation and demand only. Wider and local locational charges are not affected. We consider that all the proposals are therefore neutral for objective (b).

*Objective (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'*

We note that under the current G:D split of 27:73, NGET's charges are forecast to exceed the Regulation at some stage over the period 2015/16 to 2020/21, depending on the interpretation of Paragraph 2(1) Annex Part B of the Regulation. This is due to increasing transmission costs relative to electricity demand.

Two responses to our July consultation considered that the updated ACER guidance published in April 2014 (Opinion No. 09/2014<sup>7</sup>) should have a bearing on our decision. If the Opinion is adopted, it would remove or revise the €0-2.5/MWh range. By definition this would also remove the 'cap' that is forecast to be exceeded, and therefore make this modification unnecessary. However, it is not fully clear if, or when, the Opinion will be implemented so we must make our decision based on the existing arrangements. To take account of all eventualities, CMP224 is designed such that, if the Opinion is implemented, the G:D split will revert to the current split of 27:73.

All of the proposals take account of developments in NGET's, the other Transmission Network Owners' and Offshore Transmission Network Owners' businesses, and (to a greater or lesser degree depending on the interpretation of the Regulation used) mitigate the risk of non-compliance with the Regulation. We therefore consider that all the proposals better meet this objective compared to the current baseline.

As discussed in the 'Impact and Legal Interpretation' section of our July consultation, we consider that Paragraph 2(1) in Annex Part B of the Regulation is ambiguous and that there is a risk that charges under options that use the broad interpretation are successfully challenged by generators. We therefore consider the options that use the strict interpretation (the original proposal and WACM1) better meet this objective when compared to the options that use the broad interpretation (WACM2 and WACM3).

*Objective (d) 'compliance with the Electricity Regulation and any relevant legally binding decisions of the European Commission and/or the Agency'*

This modification has been brought forward to ensure transmission charges in GB do not exceed the upper limit set by the Regulation. The Regulation (i.e. Regulation No. 838/2010) has been adopted by the European Commission pursuant to Article 18 of the Electricity Regulation<sup>8</sup> in order to set guidelines relating to the inter-transmission system operator compensation mechanism and a common regulatory approach to transmission charging. We therefore consider that all the proposals better meet this objective compared to the current baseline.

As discussed in the 'Impact and Legal Interpretation' section of our July consultation, we consider that Paragraph 2(1) in Annex Part B of the Regulation is ambiguous and that there is a risk that charges under options that use the broad interpretation are successfully challenged by generators. We therefore consider the options that use the strict interpretation (the original proposal and WACM1) better meet this objective when compared to the options that use the broad interpretation (WACM2 and WACM3).

### **Assessment against our principal objective and statutory duties**

Our principal objective is to protect the interests of existing and future energy consumers. As discussed above, we consider that WACM1 best meets the relevant CUSC charging objectives when compared to the other proposals and current baseline. However, in our view there is a risk that the transfer of costs from generation to demand (which happens under all the

<sup>7</sup> [http://www.acer.europa.eu/Official\\_documents/Acts\\_of\\_the\\_Agency/Opinions/Opinions/ACER%20Opinion%2009-2014.pdf](http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Opinions/Opinions/ACER%20Opinion%2009-2014.pdf)

<sup>8</sup> Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009R0714&qid=1412775578598&from=EN>

proposals) has a negative impact on consumers. This will particularly be felt in the short term as generators are likely to see windfall gains which mean higher prices for consumers until all market participants fully pass through the changes in their TNUoS charges. WACM1 would have more impact than the original proposal because it transfers more costs from generation to demand.

Having considered responses to our July consultation, our view is that while it is possible that the potential benefits of more stable charges associated with setting the G:D split with a longer lead time could outweigh additional costs to consumers in the longer run, ie once market participants have had time to react, the evidence for this is not clear. We also note that, under our statutory duties, our decision is required to result in charges that comply with the range of allowable transmission charges for GB set out in Annex Part B of the Regulation. We therefore consider that the original proposal is likely to have the lowest negative impact on consumers while still ensuring that we comply with the Regulation and that approving the original proposal is in line with our principal objective and statutory duties.

**Kersti Berge**

**Partner, Transmission**

Signed on behalf of the Authority and authorised for that purpose

## Appendix 1 – summary of responses

We received twelve responses in total. Two respondents agreed with our preliminary view that we should approve the original proposal and ten disagreed. Of those that disagreed six supported the implementation of CMP224 but preferred WACM1 to the original proposal and four did not believe CMP224 should be implemented.

This appendix gives a short summary of our understanding of the responses and our views where appropriate. The full responses are available on our website.<sup>9</sup>

### Impact on predictability of charges and impact of shifting costs from generation to demand

Responses were split between two groups. Those that believe the impact on consumers of shifting costs from generation to demand will be broadly neutral because reductions in wholesale prices will balance out increases in BSUoS charges for demand customers. And those that are concerned that increases in demand charges will not be balanced by reductions in wholesale prices. Those in the former group tend to give more weight to the greater certainty provided by a longer lead time, as compared to the impact on consumers of the additional shift in costs due to the larger error margin associated with a longer lead time. The latter group tend to give more weight to the impact on consumers of shifting costs from generation to demand.

Some respondents also noted that the impact would depend upon the time scales involved. In the short run they expect that shifting costs from generation to demand will result in windfall profits for generation and that these would outweigh increased certainty associated with a longer lead time. In the longer run, they expect a reduction in wholesale prices to counter balance increases in demand charges. These respondents consider that, in the long run, increased certainty associated with a longer lead time would be beneficial to consumers.

One respondent highlighted that fixing the G:D split one year ahead only provides certainty over one component of the model used to set final tariffs and that other variables would affect the tariff after the split is fixed and longer notice wouldn't prevent that.

A number of large industrial demand users also raised general concerns about increases in demand charges and the impact this has on international competitiveness in their industries. Another respondent queried the allowed revenue forecasts used in NGET's impact analysis. The analysis used the RIIO TD1 'baseline view' forecast of allowed revenue which does not include adjustments for incentive and uncertainty mechanisms. In their view, the higher 'best view' forecast which includes these adjustments should be used. This would have resulted in the impact analysis showing a larger transfer of costs from generation to demand.

#### *Our view*

We agree that the size of the shift in costs from generation to demand depends on allowed revenue including adjustments for incentive and uncertainty mechanisms including Strategic Wider Works (SWW). However, this does not affect our view that the original proposal will have the lowest impact on consumers while ensuring compliance with the Regulation. We also note that NGET have reduced their forecast of allowed revenue over the next three years since the 'best view' and 'baseline view' forecasts were made. In their view, the baseline view is likely to be closer to actual allowed revenue (including adjustments for incentive payments and uncertainty mechanisms) than the 'best view' forecast.

We also note large demand users' concerns in respect of increasing transmission charges. We must approve either the original proposal or WACM1 to ensure compliance with the Regulation. We have considered the transfer of costs from generators to demand in our analysis. While WACM1 would result in the least transfer of costs, we consider there is a risk that the

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<sup>9</sup> <https://www.ofgem.gov.uk/publications-and-updates/consultation-connection-and-use-system-code-modification-proposal-224>

interpretation of the Regulation could be legally challenged. We therefore consider that, of the two options that use the strict interpretation, the original proposal will have the least impact on demand customers.

## **Legal interpretation**

The majority of responses agreed with our preliminary view that the strict interpretation of Paragraph 2(1) in Annex Part B of the Regulation is more persuasive and the potential for legal challenge and regulatory risk of taking a broader interpretation should be avoided.

One respondent favours the broad interpretation of the Regulation. In their view, the interpretation is legally defensible and will reduce the impact on customers. They argue that it is therefore in line with our principal objective and statutory duties to implement an option that uses the strict interpretation version.

## **CMP227**

CMP227 seeks to bring transmission charges in GB more closely into line with transmission charges in other EU member states by making a larger, one-off shift in the G:D split. The Original proposal is for a 15:85 split between generation and demand. Other options are being developed. The Workgroup consultation is available on National Grid's website and closed on 24 September.<sup>10</sup>

A number of respondents believe the adoption of CMP227 provides a more appropriate and robust long-term solution. They argue that a one-off large shift in TNUoS would provide more certainty to generators and the increase in demand charges would be balanced by lower wholesale prices.

### *Our view*

CMP227 is still in the working group stage and it is not clear whether it will be implemented. We do not therefore consider it would be appropriate to delay the implementation of CMP224 and we will make our decision on future modifications when the proposal has been finalised.

## **ACER's G-charge opinion**

On 15 April 2014, the Agency for Co-Operation of Energy Regulators (ACER) submitted to the European Commission its opinion<sup>11</sup> on the appropriate charge ranges under the Regulation from 1 January 2015. ACER's view is that the Regulation should no longer restrict average transmission charges. Instead, ACER recommends that transmission charges on output (ie £/kWh) should be prohibited and that charges on capacity (£/kW) and 'lump sum' charges should not be restricted. If implemented, this would mean that GB charges would no longer be restricted by the Regulation.

Respondents queried whether it was necessary to implement CMP224 given that, if implemented, the opinion would make CMP224 unnecessary.

### *Our view*

We note that there is no requirement on the EC to implement the ACER opinion and that, if they do, it is, in our view, unlikely that changes to the Regulation will be made until after 1 January 2015. Therefore it is important to have arrangements in place to avoid potentially exceeding the upper limit set by the Regulation in 2015/16.

We also note that if the ACER opinion is implemented CMP224 would no longer have any effect and the G:D split would revert to the current 27:73 split between generation and demand.

<sup>10</sup> <http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP227/>

<sup>11</sup> [http://www.acer.europa.eu/Official\\_documents/Acts\\_of\\_the\\_Agency/Opinions/Opinions/ACER%20Opinion%2009-2014.pdf](http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Opinions/Opinions/ACER%20Opinion%2009-2014.pdf)