

Modification proposal:	Use of System Charging Methodology Modification Proposal GB ECM-21: "Implementing a mid year tariff change"		
Decision:	The Authority directs that modification proposal GB ECM-21 shall be made		
Target audience:	Transmission system users and all other relevant stakeholders		
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Summary

This document contains the reasons for the Authority's decision **not to veto** Modification Proposal GB ECM-21: "Implementing a mid year tariff change" on the grounds that, on balance, it better facilitates the relevant objectives as specified in National Grid Electricity Transmission plc's (NGET's) electricity transmission licence. We therefore direct that the modification be made.

This letter sets out the background to the proposed modification, explains the modification, and sets out the reasons for the Authority's decision.

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Background to the Modification Proposal

Standard condition (SLC) C4 ('Charges for use of system') of the electricity transmission licence requires NGET to produce a use of system charging methodology statement setting out the basis of charges for use of the electricity transmission network across the whole of Great Britain (GB). In addition, SLC C5 ('Use of system charging methodology') requires NGET to keep its methodology under review at all times and to make proposals to modify that methodology where it considers a modification would better achieve the relevant objectives¹ in relation to: a) competition, b) cost-reflectivity and c) developments in the licensees' transmission businesses.

There are a number of provisions within the current regulatory framework that are designed to enhance the stability, and promote the predictability of Transmission Network Use of System (TNUoS) tariff levels. Specifically, SLC C4 5(a) states that NGET must give the Authority 150 days notice of any proposal to change use of system charges; and Section 3.14.3 of the Connection and Use of System Code (CUSC) requires NGET to provide users 2 months advanced written notice of any revised charges.²

In accordance with the default notification timescales, NGET has developed supporting charge setting processes to guide the relevant licensees towards providing forecast revenue information to NGET in a manner designed to avoid introducing changes to tariff levels within a financial year. For example, SO-TO Code Processes (STCPs) 13-1 and 14-1 requires each transmission licensee to send NGET their best forecast of its revenue requirement for the next financial year by 1 November (i.e. 150 days before the start of the next charging year). In addition, STCP 14-1 requires licensees' final forecast revenue to be submitted by them to NGET by 25 January to allow NGET to publish tariffs for the next financial year by 1 February and provide the default written notice required by the CUSC.

¹ The relevant objectives are contained in SLC C5 5.

² The Authority has the power to consent to a shorter notice period on request in both cases.

In practice, the effect of these provisions has led NGET to make every effort to calculate and fix 'wider' zonal TNUoS tariff levels at a single value for the full financial year. Although the current contractual framework permits changes to TNUoS tariff levels and charges 'within year', the text of the Statement of the Use of System Methodology replicates the default or 'standard' charge setting process applied by NGET and is silent on how to implement changes to tariffs within a financial year.

Implicit within the charge setting process is the need to make forecasts when calculating the allowed revenue. To date the total allowed revenue has been comprised of relatively stable forecast cost submissions by the onshore Transmission Owners (TOs). However, the GB transmission system and the types of generation connecting to it are changing significantly. As a result, the transmission system needs to adapt to accommodate these changes.

NGET explains that the trigger event that has brought this issue to the fore is the proposed introduction of the offshore electricity transmission regime.³ However, the intention is that the proposed process could be applied in any circumstances where there is a material change to allowed revenues. In such circumstances it will be necessary to change TNUoS tariff levels within a financial year to ensure that the tariffs are targeted to recover the correct total allowed revenue for all licensees.

The modification proposal

On 16 March 2010, NGET submitted the Conclusions Report ("the Report") on Modification Proposal GB ECM-21⁴ to the Authority for a decision. The Report recommended to the Authority that a modification is required to the Statement of the Use of System Charging Methodology in the form of further explanatory text for the following reasons:

1. To describe the process that NGET would adopt in progressing changes to the TNUoS tariff levels within a financial year in accordance with the current regulatory framework;
2. To clearly define how users' charges would be determined and users' annual liability would be calculated and change throughout the year in the event that there are changes to the TNUoS tariff levels within a financial year; and
3. To clarify the process that NGET would adopt to deal with any potential over or under recoveries as a result of external events.

NGET considers that such a change is required to ensure that the TNUoS tariff levels remain reasonably cost reflective and/or reflect developments to the network and allow NGET to recover the costs of the entire transmission system within the financial year in which they are incurred (reflecting the correct allowed revenue costs of each transmission licensee). Further detail on the Modification Proposal can be found on NGET's website www.nationalgrid.com.

The proposed modification is not seeking to alter or modify the principles of the core methodology by which NGET calculates and derives TNUoS tariff levels and individual charges for both demand users and generators, onshore and offshore. Instead, the Report explains that the revenue effect of the proposed modification will be focused on the residual components of the TNUoS charge (both generation and demand) and local components of the TNUoS charge (generation users only). This means that the onshore zonal locational differentials will remain unaltered and only the non-locational residual part of the TNUoS tariff will change.

The main features of NGET's proposed approach are set out below.

³ The Government has indicated that the go-live date for the offshore regime is June 2010 which is part way through the 2010/11 charging year. The introduction of the offshore regime will therefore introduce significant uncertainties into the TNUoS tariff setting process. This uncertainty arises as the revenue requirements of the OFTO and other key charging information (such as assets values and ratings) are only known after the 'standard' charge setting process has concluded.

⁴ The conclusions report for GB ECM-21 is available from National Grid's website at www.nationalgrid.com

Timeline

The Report notes that NGET will 'endeavour' to implement a mid year change to TNUoS tariff levels and charges in October of each charging year. NGET's rationale for this aspirational date is to minimise the uncertainty for users and align with the current default processes. The inclusion of an aspirational date (October) does not mean that it would only be possible to change tariffs once within a charging year. NGET recognises that circumstances may transpire that make it impossible to meet an October date and acknowledges that it may need to change tariffs at other times as conditions warrant. For example, offshore projects are commissioned throughout the year and there may not be sufficient information available to set tariffs to meet an October deadline.

Calculation of generators annual liability

The practical consequences of Modification Proposal GB ECM-21 will manifest through the charge setting process applied by NGET and the calculation of users' monthly and annual liabilities. Under the model presented by NGET, a user's annual liability will be calculated by prorating the affected tariffs across the months in which they are applicable. In this way TNUoS tariffs and charges are not back dated. The Report sets out the algebraic formula by which the annual liability for each component of a generators charge, half hourly demand customer, non-half hourly demand customer and monthly charges would be calculated.

Dealing with uncertainties when charge setting

NGET's intention is for updated tariffs to be fixed for the remainder of the financial year. In the case of the introduction of the offshore regime, NGET proposes that subsequent changes to the data provided by the preferred bidder, identified through the tender process, would not be used to make further updates to onshore or offshore tariffs within year. Any resultant over or under recoveries would be adjusted the following year through the relevant Kt mechanism.

Implementation

NGET is seeking to implement the modification proposal from the date that the Authority issues a non-veto direction.

NGET's recommendation

In the Report to the Authority, NGET indicated that after consideration of the responses received in relation to its charging consultation on GB ECM-21, it considers that this modification, and the associated amendments to the Statement of the Use of System Methodology, will better facilitate the achievement of relevant objectives (b) and (c) as specified in NGET's electricity transmission licence. In terms of objective (a), NGET considers that the reduced predictability of tariffs is largely outside the control of NGET and in any case can be mitigated through the publication of timely information that enables industry participants to assess alternative scenarios and sensitivities. NGET submitted the Modification Proposal to the Authority for consideration on 16 March 2010.

The Authority's decision

The Authority is required to assess any proposed modification to the use of system charging methodology and to decide whether to approve or veto such a change.

The Authority has considered the issues raised by GB ECM-21, taking into account the views put forward by industry participants during the consultation process. The Authority has concluded, based on the information in front of it, that on balance:

1. Implementation of GB ECM-21 would better facilitate the achievement of the relevant objectives specified in NGET's electricity transmission licence; and
2. Implementation of GB ECM-21 is consistent with the Authority's principal objective and wider statutory duties.

The Authority has therefore decided **not to veto** the modification proposal.

Reasons for the Authority's decision

It is important to reiterate that although the current contractual framework permits changes to TNUoS tariff levels and charges 'within year', the text of the Statement of the Use of System Methodology is silent on the process by which this would be accommodated. Hence, the main thrust of the Modification Proposal is a clarificatory change to the text of the Statement, in accordance with the current regulatory framework, coupled with a description of how users' charges would be determined and users' annual liability would be calculated. The core underlying charging methodology and the way that the level of TNUoS tariffs and charges are calculated will remain unchanged.

Against this background, in this section we set out the key issues that informed the Authority's decision and detail the Authority's assessment of the modification proposal against both the relevant objectives specified in SLC C5 5 of NGET's electricity transmission licence and its statutory duties. These sections contain reference to respondents' views where appropriate.

SLC C5 5(a) – Facilitates effective competition in the generation and supply of electricity and facilitates competition in the sale, distribution and purchase of electricity

The Modification Proposal is a clarificatory change to the text of the Statement. With this in mind, we consider that GB ECM-21 is neutral towards the achievement of SLC C5 5 (a).

In general, competition is more likely to be effective if costs which parties impose are reflected in the charges they pay and thus are appropriately factored into their commercial decisions. The introduction of more cost reflective charging arrangements would be expected to promote more effective competition. Factors affecting promotion of competition are considered below:

- Stability and predictability of tariffs
- Likelihood of behavioural change; and
- Any additional undue complexity.

Stability and predictability

We acknowledge the views of NGET that while the proposals will clarify the processes that NGET would adopt in progressing changes to the TNUoS tariff levels within a financial year in accordance with the current regulatory framework, this in itself is not an indication of tariff instability. We note that the potential unpredictability of the TNUoS tariff impact is primarily due to the absence of extra information beyond what is already in the public domain, not the way the charges are calculated or the process for setting charges.

While the GB transmission system and the types of generation connecting to it are changing markedly, and hence there is an increased probability for multiple TNUoS tariff levels within a financial year, we note that the proposal simply seeks to clarify that NGET is permitted to make changes to the TNUoS tariff levels within a financial year in accordance with the current regulatory framework.

Notwithstanding the increased potential for multiple TNUoS tariffs, as generators and suppliers would not know 'final' TNUoS tariff levels until part way through the year, we are of the opinion that the reduced predictability of such tariffs is largely outside the control of NGET and agree with NGET that the impact can be mitigated through the publication of timely information that enables industry participants to assess alternative scenarios and sensitivities.

In terms of the process to calculate and determine users' monthly and annual liabilities, we note that the proposal intends to adopt an approach that is similar to how revised liabilities are determined onshore when suppliers amend their forecast chargeable volumes or when generators increase Transmission Entry Capacity within year. More importantly, the proposal simply clarifies how the existing procedures would be extended to cover mid year changes without changing the underlying methodology or regulatory framework. The core underlying charging methodology and the way that the level of TNUoS tariffs and charges are calculated will remain unchanged. It is also clear that the proposal would change the non-locational wider generation and demand residual elements of the wider TNUoS tariff for all users. As this tariff component is the same for each class of user, assuming all users have access to the same

indicative tariff information, a mid year tariff change will not affect the relative competitiveness of generators or suppliers across GB.

Against this background, the expectation is that the proposal will not reduce the transparency of the calculation of TNUoS tariffs and monthly/annual liabilities.

Can users respond to the cost signals of a mid year change

We note the views of a respondent suggesting that NGET's preferred model could not incentivise behaviour among market participants to the wider benefit of competition or the end consumer. We consider this issue to be outside the scope of the proposed modification.

NGET has indicated that they remain unconvinced that users would be unable to respond to the cost signals that this proposal would give and considers that parties already react to costs that are changing year on year. For example, Balancing Service Use of System costs change continually and the industry factor in the risk of this cost change.

We note that as a general principle the industry would like as much clarity and prior warning of changing costs. In response, NGET has indicated that it will endeavour to supply information and set out a clear timeline to this effect. In addition, it is clear that the most influential factor in the coming financial year is the ability of NGET to accurately forecast offshore revenue flows and the capital requirements of offshore projects. For these factors we note that NGET does not have any extra information beyond what is already in the public domain. Therefore industry participants are on an equivalent footing when forecasting offshore revenues.

One respondent made the additional point that small suppliers would be adversely affected by the proposed change more so than other industry participants as they do not have the resources to track and predict TNUoS charge changes. Smaller parties might be further disadvantaged in this respect as they would not benefit from the extra information that NGET intends to publish. We note NGET's response to this issue, that the potential changes to TNUoS tariff levels and charges is expected to be relatively small compared to a suppliers' annual liability and will have similar effect across all sizes of supplier. We note that this appears to be corroborated by the analysis provided by NGET in the Report forecasting the potential movement in charges in a variety of scenarios. We also note that NGET currently publishes several information sources on its website that provide annual information designed to help users understand TNUoS tariffs (e.g. information notes and methodology seminars).

Finally, we understand that any users with particular issues on any aspect of the charging methodology or supporting processes is encouraged to contact NGET's transmission charging team directly to raise and discuss any ongoing concerns.

Complexity

We note that respondents claimed that the process of forecasting GB ECM-21 charges is highly complex.

It is important to reiterate that the current contractual framework permits changes to TNUoS tariff levels and charges within year. This proposal should therefore have no impact on anything other than clarity.

However, we must weigh any perceived increase in complexity of the charging structure against the overall benefit that the modification proposal might bring. We note that NGET will publish information as it becomes available to them. We also note that the unpredictability of the TNUoS tariff impact would primarily arise due to the absence of extra information beyond what is already in the public domain, not the way the charges are calculated.

NGET has indicated that it recognises the benefits of giving the industry sufficient notice of any tariff change. It is also NGET's intention for industry participants to continue to receive at least 2 months written notice before a mid year change takes effect. In accordance with the aspirational October change date, NGET therefore intends to provide users with written notification of the change in tariffs and charges at the end of July for implementation in October. NGET has however indicated that it would keep this aspect of the arrangements under review.

SLC C5 5(b) – Cost reflectivity – charges which reflect, as far as reasonably practicable, the costs incurred

We consider that on balance GB ECM-21 does better facilitate SLC C5 (5) (b).

We feel it is correct that TNUoS tariff levels and charges should as far as reasonably practicable reflect the costs imposed on the system arising from generator's commercial choices. The introduction of charges that more accurately reflect the costs incurred by users would be expected to promote more effective competition.

We note the importance of stable tariffs to underpin investment decisions. We recognise that there are a number of provisions within the current regulatory framework, reflected in NGET's TNUoS charging methodology itself, which enhance the stability and predictability of TNUoS tariff and charge levels. We also note that NGET has a licence obligation to ensure that tariffs are cost reflective, and limiting the ability of tariffs to respond to potentially significant within-year events reduces the ability of NGET to recover the costs of the entire transmission system within the financial year in which they are incurred (reflecting the correct allowed revenue costs of each transmission licensee). Further, we note the view of NGET that, other things remaining equal, the stability of tariffs year on year will increase with a model that allows the pass through of costs as soon as they are known.

We note that the basic intention of NGET's proposals is to delay revising tariffs until the best available information on allowed revenues is made available. In the case of the offshore regime, this will mean delaying the revision of tariffs until such times as a better forecast of OFTO revenue information can be made available by the preferred bidder (identified via the offshore tender process), who is best placed to assess its own costs. It is clear that this better information will enable NGET to set:

- More accurate 'local' offshore TNUoS charges for the relevant offshore generator; and
- More accurate residual element of the TNUoS charge (a component of the wider TNUoS tariff) for both generation and demand users, which ensures that:
 - All TOs' allowed revenue costs are recovered from appropriate users; and
 - The sum of all TO revenue streams (onshore and offshore) are recovered in the correct proportions (27:73) between generation and demand.

For the reasons given above we are of the opinion that the proposal will result in more cost reflective tariffs. It is also justified since the changes proposed in the calculation of monthly/annual liabilities in the manner suggested by NGET will improve the accuracy of such liabilities for all affected users.

SLC C5 5(c) – Properly taking account of developments in the transmission system

We consider that on balance GB ECM-21 does properly take into account developments in the GB transmission system.

Modification Proposal GB ECM-21 recognises that the existing charge setting process reflected in the text of the Statement of the Use of System Methodology does not reflect the inherent flexibility of the current regulatory framework and is silent on how to implement changes to the TNUoS tariff levels within a financial year and seeks to address this.

The Report explains that the trigger event that has brought this issue to the fore is the proposed introduction of the offshore electricity transmission regime. Taking this event as an example, we consider that the proposal enables NGET to take full account of information made available from the preferred bidder identified through the offshore tender process. Specifically, by delaying the publication of revised final tariffs until a substantive milestone in the tender process has been reached (i.e. when the preferred bidder has been identified via the tender process and has acceded to the SO/TO Code), relevant information can be used in the charge setting process. Until that point, the information available to NGET is incomplete and tariff and individual charges would have been set without any regard of the forecast revenues of the Preferred Bidder. Accordingly, we agree with NGET's conclusion that the introduction of the proposal takes best account of an offshore tender process in the GB charge setting process.

We note the ability of the proposal to be applied in any circumstance where there is a material change that makes it necessary to change TNUoS tariff levels within a financial year.

We are currently of the view that the proposal will complement the changing nature of the transmission network and provide more cost reflective signals to users therefore assisting the development of an economic and efficient transmission system.

Assessment against the Authority's statutory objectives and duties

As well as evaluating how the modification proposal would facilitate the relevant objectives, the Authority must consider whether the implementation of GB ECM-21 is consistent with its principal objective and statutory duties.

We note that the proposed modification is not seeking to alter or modify the principles and the core methodology by which NGET calculates and derives TNUoS tariff levels. As such, the principles of the core methodology, approved by the Authority in 2005, by which NGET calculates and derives TNUoS tariff levels and individual charges for both demand users and generators, onshore and offshore will remain unchanged by the proposed modification. Hence, the Modification Proposal is just a clarificatory change to the text of the Statement of the Use of System Charging Methodology.

Overall and on balance, we consider that GB ECM-21 is consistent with the Authority's principal objective and statutory obligations. On this basis we consider a non-veto decision is justified.

Our assessment overall

We have set out above why we consider that GB ECM-21 does on balance better facilitate the applicable objectives, and why we consider it is consistent with the Authority's legal duties and principal objective of protecting existing and future consumers.

Decision notice

In accordance with, the Authority has therefore decided not to veto the modification proposal GB ECM-21.

We expect NGET to implement the modification proposal immediately; hence the modification will take effect immediately to coincide with the date of this decision as requested by NGET.

Stuart Cook



Senior Partner, Transmission and Governance
Signed on behalf of the Authority and authorised for that purpose