Modification proposal:	**Use of System Charging Methodology Modification Proposal GB ECM-26:** "Review of interconnector charging arrangements"		
Decision:	**The Authority has decided not to veto Modification Proposal GB ECM-26**		
Target audience:	**All transmission system users, including interconnector owners, and all other relevant stakeholders**		
Date of publication:	4 October 2010	Implementation Date:	1 April 2010

Background to the Modification Proposal

Under the terms of its licence[1], National Grid Electricity Transmission plc (NGET) is required to produce a use of system charging methodology statement setting out the basis of charges for use of the National Electricity Transmission System (NETS)[2]. In addition, NGET is required to keep the Use of System Charging Methodology under review at all times and to make proposals to modify the methodology where it considers that a modification would better achieve the relevant objectives[3].

The NETS is linked to other countries through dedicated links called interconnectors[4]. The interconnectors facilitate import and export energy in and out of Great Britain.

In NGET's Transmission Network Use of System (TNUoS) charging methodology, interconnector asset owners (IOs)[5] are currently liable for charges for use of the NETS associated with import and export flows.

IOs are therefore currently liable for: Generation TNUoS tariffs, when importing power; and for Demand TNUoS tariffs applicable to all half hourly (HH) demand users, for export over the peak demand periods (or Triad[6]). In regards to the transport model underpinning NGET's TNUoS charging methodology, the export of energy from the NETS by interconnectors contributes to the setting of the relevant Triad periods upon which Demand TNUoS charges will be calculated. Charges levied by NGET on IOs are then levied by IOs on users of the interconnector assets on a neutral "pass through" basis.[7]

In addition to the national regulatory and legislative framework, NGET is also obliged to ensure compliance of the national charging arrangements with EU legislation directly applicable to national Transmission System Operators (TSOs). In the context of network charging arrangements and interconnectors, the principal EU legislation and requirements are set out in:

- Regulation EC No 1228/2003 on conditions for the access to the network for cross border exchanges in electricity; part of the 'second package' of EU legislation on electricity; and
- Regulation EC No 714/2009. Part of the 'third package' of EU legislation on electricity.

The relevant provisions are described in the table below.

[1] Standard licence condition (SLC) C4 ('Charges for use of system') of the electricity transmission licence.
[2] The NETS (currently split into three transmission licence areas which are defined as England and Wales, South of Scotland and North of Scotland) will be extended into offshore waters at a point where assets are treated as part of the NETS.
[3] SLC C5 (5) of NGET's electricity transmission licence.
[4] There are two existing interconnectors between GB and other markets – the Interconnexion France-Angleterre (IFA) and the Moyle Interconnector. Both projects are regulated in the sense of requiring an interconnector licence. The Authority has no powers to request Moyle to review its charging methodology (SLC 10 is switched off); this is a matter for NIAUR.
[5] IOs that have a Bilateral Connection Agreement with NGET and/or capable of exporting 100MW or more.
[6] Metered consumption on the three highest demand periods occurring during November to March.
[7] Generation TNUoS charges are passed through pro-rata to the amount of capacity allocated in an import direction (e.g. France to England in the case of IFA) and Demand TNUoS charges are passed through pro-rata to Users based on nominated flows contributing to a Net Interconnector Export direction (e.g. England to France) during a Triad period.

	1228/2003[8]	714/2009	Explanation
Inter-TSO compensation mechanism ("ITC")	Article 3	Article 13	This mechanism is designed to compensate TSO for the costs they incur as a result of hosting cross-border flows of electricity on their networks.
Charges for access to networks	Article 4(3)	Article 14(3)	Requires charges for network access to take account of payments and receipts resulting from the ITC mechanism.
	Article 4(4)	Article 14(4)	Charges for access to networks shall be applied regardless of the countries of destination and, origin, respectively, of the electricity.
	Article 4(5)	Article 14(5)	There shall be no specific network charge on individual transactions for declared transits of electricity.

Under the second and third package legislation an interconnector is defined as a transmission line[9]. As a consequence, in the context of the EU Internal Market in Electricity, interconnector flows are neither classed as production (generation) nor consumption (demand), but part of the overall transmission infrastructure facilitating the wider market and to be certified and designated as a TSO. Furthermore, EU legislation enables a TSO to receive compensation for hosting cross border flows through a mandatory ITC mechanism.

This treatment of interconnectors was underlined by the European Commission (EC) in a series of requests sent to member states to implement and apply in full various aspects of EU legislation to ensure a Single Market for gas and electricity.[10] In the context of the UK, the correspondence provided a 'reasoned opinion' that the provisions on network charges are not in line with the requirements of Regulation 1228/2003[11].

The above policy position has also been reflected in the development of the mandatory ITC mechanism between all member states. This mechanism, which has operated on a voluntary basis, is binding from 22 September 2010. Cross-border flows of electricity are not liable for 'additional' transmission charges, except in so far as these result from congestion management revenue. Under European law, the ITC mechanism is deemed to be the correct mechanism to compensate NGET for hosting cross-border flows in accordance with Article 4 of Regulation 1228/2003.

These developments have led NGET to review the charging system and the interconnector charging arrangements in particular. NGET published a consultation in July 2010 proposing that IOs be treated as a separate class of transmission users as distinct from generation or demand and that they be exempt from both TNUoS demand and generation charges.

The Modification Proposal

On 6 September 2010, NGET submitted a Conclusions Report ("the Report") on Modification Proposal GB ECM-26 to the Authority for a decision. The Report recommended to the Authority that two broad changes to the Use of System Charging Methodology are made, as set out below:

i. Interconnectors are not treated as generation or demand and thus not liable for either TNUoS demand and generation charges; and

[8] The provisions of the 'second package' Regulation (1228/2003) will expire on the 2nd March 2011 and be replaced by the third package Regulation (714/2009). The provisions of Regulation 714/2009 will have direct effect from 3 March 2011.
[9] Article 2 of Regulation 1228/2003 (and 714/2009) defines an 'interconnector' as "*a transmission line which crosses or spans a border between two member states and connects transmission systems of member states*".
[10] Further information about the infringement procedures was published on the Europa website on 24 June 2010. Follow link: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/275&format=HTML&aged=0&language=EN&guiLanguage=en
[11] Ofgem is of the opinion that the Commission's position is arguable rather than definitive, but considers it is prudent at this stage to give it due consideration, without prejudice to the position of the UK Government.

ii. Interconnector flows will not be included when determining the Triad demand periods upon which GB demand TNUoS charges will be calculated.

In addition, we note that NGET's Report contains a clarification in terms of how it intends to treat interconnectors as inputs to the transport model. The Report notes that NGET will maintain the approach currently applied whereby interconnectors are modelled with the full capacity to import to reflect the potential contribution to security of demand rather than any forecast of actual output. We note that this modelling assumption does not explicitly feature in the Use of System Methodology and therefore does not result in a change to the text of the statement.

NGET's recommendation

NGET is seeking to implement the proposed changes into the charging methodology statements on 5 October 2010, and for ECM-26 to be applicable for the charging year beginning 1 April 2010 if the Authority issues a decision not to veto. Further detail on GB ECM-26 can be found on NGET's website www.nationalgrid.com.

In the Report to the Authority, NGET has explained that after consideration of responses, it considers that the modifications to the Use of System Charging Methodology will better achieve the relevant objectives as specified in NGET's electricity transmission licence.

The Authority's decision

The Authority is required to assess any proposed modification to NGET's Use of System Charging Methodology and decide whether to issue a direction to veto such a change.

The Authority has considered the issues raised by GB ECM-26 and, in reaching a decision, the Authority has taken into account the views put forward by industry as well as assessing the modification against the relevant objectives of NGET's electricity transmission licence. The Authority has concluded that:

- Implementation of GB ECM-26 would better achieve the relevant objectives of NGET's electricity transmission licence; and

- Implementation of GB ECM-26 is consistent with the Authority's principal objectives and wider statutory duties.

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

Reasons for the Authority's decision

The Authority recognises that the changes proposed through GB ECM-26 seek to reflect the policy approach being adopted through the implementation of the third package of legislation, whereby a mandatory ITC mechanism will compensate TSOs for cross border flows and IOs will be certified as TSOs. These measures further promote the single Internal Market in Electricity and bring the UK treatment of interconnector links in line with the default position across Europe.

We consider that the proposed changes are necessary to conform with European law.

We are of the opinion that the proposal to exclude interconnector export flows when determining the Triad demand is consistent with the intent of EU legislation and would ensure that the GB tariff is based on net GB demand rather than any wider European market influences.

We note NGET's clarification of its treatment of interconnectors within the transport model and its explanation to use the full capacity to import as an input to the transport model.

We acknowledge that NGET's intention is for the proposed changes to be effective within this charging year for two reasons. First, to ensure compliance with the relevant provisions of EU legislation ahead of Winter 2010/11 and to avoid influencing the Triad period and charges of the current charging year and, second, to be consistent with the application of the mandatory ITC scheme from 22 September 2010.

Furthermore, we note that NGET's intention is for the proposals to be incorporated into the charging methodology statements to take effect as of 5 October 2010, and for the charging changes to be applicable to the full charging year from 1 April 2010 to 31 March 2011. We acknowledge the views of some respondents that the proposals should not be applied to tariffs within the current charging year. However, for the reasons set out below, we consider that the application of the revised tariffs to the entire tariff year are appropriate.

We note that NGET's proposed approach is based on the extension of the following established principles:

- The individual charge that a user will pay is based on an annual system access product[12].
- Thus, each licensee is required to provide their best forecast of its revenue requirement for the next full financial year.
- This information allows NGET to calculate and fix zonal tariffs levels at a single value for the full financial year on an ex-ante basis in accordance with the charging methodology.

Against this background, NGET is of the opinion that continuing to treat TEC and Triad demand as annual products is simplest and most consistent treatment of TNUoS. NGET also considers this is the only option that achieves the wider objectives (i.e. compliance with EU law) in a timely manner. As such, NGET proposes that changes to the TNUoS tariffs are therefore made applicable from the beginning of the current charging year, 1 April 2010.

We are of the opinion that, when taken together, there are reasonable grounds that warrant the retrospective application of the proposed charging changes to the charging year from 1 April 2010 to 31 March 2011.

Against this background, in the next section we set out the key issues that informed the Authority's decision and the Authority's assessment of GB ECM-26 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

We consider that overall, the methodology changes associated with GB ECM-26 better achieve SLC C5(5)(a). We consider that the modification is necessary to conform with European law and is likely to have a broadly beneficial impact on competition by providing a consistent basis upon which all parties compete with each other in the wider European market.

In broad terms, the proposals could impact on competition by providing consistent charging arrangements to parties that import and export electricity across Europe, impacting the basis upon which all parties compete with each other in terms of cross-border trade.

We also note that the recently introduced mandatory ITC mechanism is intended to remunerate TSOs for accommodating cross-border flows and that the current arrangement give rise to a situation where the ITC mechanism overlaps with TNUoS charges. The proposed change would remove a potential of distortion of competition between domestic and cross-border users of the GB transmission system. This in turn may improve the ability of parties to trade effectively in the GB wholesale market and better promote effective competition overall.

[12] An ex-ante level of capacity for generators, or Transmission Entry Capacity (TEC), and an equivalent proxy for an annual demand product, based on metered consumption over the Triad period.

In terms of the proposed change to remove interconnector export flows from determining Triad charges, we acknowledge the views expressed by NGET that the proposal ensures that GB market participants are not unduly affected by the setting of Triad periods based on flows that are not subject to the same signal. We also note that the modification delivers a solution that is consistent with the relevant EU legislation and provides a policy approach that will allow competition to develop on a level playing field in the wider European market.

In addition we note that removing GB transmission charges from interconnectors would address market parties' concerns that GB transmission charging arrangements distort cross-border trade and are not consistent with the requirement of the Regulation 1228/2003 (and 714/2009).

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

We consider that the changes associated with GB ECM-26 better achieve SLC C5(5)(b).

We acknowledge that GB ECM-26 is aimed at aligning the overall cost reflectivity of the TNUoS methodology with the introduction of the mandatory ITC mechanism and forthcoming Third Package implementation.

We note that under Regulation 1228/2003 the mandatory ITC mechanism is intended to be the means by which a TSO would be compensated for the consequent impact of an interconnector on their national system. Continuing to levy TNUoS charges on the IOs would give rise to the IOs being exposed to overlapping charges for the same costs. We note that the overall effectiveness of the ITC mechanism is an issue for the EC and we would expect this to be kept under review to facilitate any enhancements in its application. However, we consider that the proposed changes of excluding the IOs from TNUoS charges would better reflect the costs the cross border flows incur on the GB transmission system.

Finally, we note that some respondents suggested that Balancing Services Use of System (BSUoS) charges should also fall within the scope of the charges to be removed from interconnector users. We note the view expressed by NGET that the relevant EU legislation relates only to 'access' (i.e. TNUoS) charges and does not include 'operational' (i.e. BSUoS) charges. NGET's Report therefore contains no proposals that relate to modification of the BSUoS charges under the Statement of Use of System Charging Methodology.

In conclusion, we are of the opinion that the proposed changes will avoid the risk of overlapping charges and that the proposed modification by NGET is therefore likely to improve the cost reflectivity of charges in a manner consistent with the relevant legislative measures. The introduction of a mandatory ITC mechanism coupled with the removal of TNUoS charges on interconnector users will eliminate the potential for 'double counting' of revenues.

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

We consider that the methodology changes associated with GB ECM-26 better achieve SLC C5(5)(c).

We are of the view that GB ECM-26 will complement the changing nature of the wider European market as envisaged by the intent of the applicable European legislation, in particular by clarifying further and refining the use of system charging arrangements applicable to interconnector circuits and appropriate recovery of ITC charges in the individual members states through the mandatory ITC mechanism.

We consider that GB ECM-26 is compatible with the developments in NGET's transmission business in relation to its role and responsibilities as system operator in GB as well as the wider development of the regulatory framework for electricity transmission across Europe.

Assessment against the Authority's statutory objectives and duties

As well as evaluating how the modification would facilitate the relevant objectives, the Authority must consider whether the implementation of GB ECM-26 is consistent with its principal objective and statutory duties.

We are of the view that the modification:

- Is likely to support more effective competition than otherwise would be the case;
- Will not have a material impact on sustainable development; and
- May encourage the construction of new projects which in turn could improve security of supply and increase competition overall.

Overall, we consider that the modification is consistent with the Authority's principal objective and statutory obligations. On this basis we consider a decision not to veto is justified.

Our assessment overall

We consider that GB ECM-26 does better achieve the relevant objectives, and is consistent with the Authority's statutory duties.

Decision notice

In accordance with, the Authority has therefore decided not to veto Modification Proposal GB ECM-26.

We expect NGET to implement the modification proposal in the manner proposed; hence the modification will take effect on 5 October 2010 and be applicable from the charging year beginning 1 April 2010 as requested by NGET.

Stuart Cook

Senior Partner, Smarter Grids & Governance
Signed on behalf of the Authority and authorised for that purpose