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Response to OFGEM
PROJECT TRANSMIT: next steps on connections issues

Dear Ms Nixon,

Thank you for the opportunity to reply to your letter of 22nd March in which you asked for a response, in particular, to Electricity Connection issues as part of the ongoing project TransmiT.

Your letter went on to outline the nature of the problem – which is the real or perceived risk of new or existing network assets becoming 'stranded' – and a range of possible measures which may protect such assets from becoming a burden on consumers.

Stranded Assets

The definition of a 'stranded asset' seems to be one where Ofgem refuses to allow National Grid (as System Operator) to bring the built asset into the charging base for its allowed return on investment; or an asset is allowed but is subsequently unused. In the former case it would seem that National Grid, the 2 other TOs, and their shareholders, would be at risk of building without a guaranteed return. In the latter case the consumer would pay for the remainder of the life of the asset and at the level of its allowed return – provided no other users could be found to fill the capacity.

Measures to remove risk – to date

To date the measures have involved demanding significant and progressive securities against the whole value of network assets for the duration, to commissioning, of a project leading to a new generator connecting to the Network. The deepest version of this system is 'Final Sums' whereby the spend profile of the Transmission Owner (TO) is estimated 6-monthly and at 6 –monthly intervals and securities asked of the pre-commissioning generator. Developers were offered a generic version of User Commitment after CAP131 was rejected by the Authority but allowed as an interim measure as IGUCM.

A key feature of the Generic model is that the generator developer is only asked for about half the estimate of spend with 'demand' liable for the remainder. A number, usually 10, times TNUoS is used as a proxy rather than the actual cost of the assets with securities ramped up in 25% increments from year 4 before to the year of commissioning. For developers who sign connection agreements more than 4 years out from the connection date, securities of £1/kW, £2/kW and £3/kW are demanded from 7 to 5 years out respectively. These sums are not repayable in the event that the developer terminates, even if the assets are subsequently fully utilised by others.

At the same time it has been assumed by much of the industry that, once commissioned, generators on the system would pose no risk of stranding assets, since they had already sunk costs and that, in the event of a company failure, another would take over the generating assets.

It was this imbalance in the demand for liabilities and posted securities between Pre-Commissioning and Post –Commissioning generators, which Ofgem cited as the principal reason for not allowing CAP 131 as an enduring model for User Commitment.

High Level Principals

It is against this background that issues raised in project TransmiT stand out in relief.

The overarching assumption, still, is that the risk of asset stranding is both real and significant enough to pose a financial drain on consumers through their electricity bills.

It is also apparent, and reflected in the H L Principals, that the measures put in place to date, have not been fair in the treatment of Pre and Post Commissioning generators. It had assumed 100% risk at all times for Pre-Commissioning and 0% risk for Post-Commissioning.
Several parties primarily, but not exclusively, developing Renewables projects in peripheral areas – most notably in the North of Scotland and the Islands – reported problems dealing with the very high levels of User Commitment and associated securities demanded when, at the same time, they had to cover the very high investment costs of the projects.
There is evidence that one major generation developer – which had been asked to provide 100% of the securities for a strategically important Transmission connection to a Scottish Island group – terminated its agreements in 2009 when faced with demands for ever-mounting securities. This coupled with quotes for very high TNUoS was cited by the party concerned and was reported in the press at the time.

Ofgem states, in its H L Principals, that enduring arrangements should not burden consumers with excessive or inappropriate costs on the one hand whilst being transparent, proportionate, non-discriminatory and avoid being a barrier to entry (including renewables) or adversely affect security of supply on the other.
Ofgem also states that energy supplies should be sustainable, and offer value for money for both existing and future consumers.

There is a danger that, whilst trying to encompass so many conditions, the focus on identifying and quantifying real risks of inefficient investment, and dealing with them, may be lost.

It is disconcerting that an unfair system – loading liability and demands for security on only one class of generators (Pre-Commissioning)- may be succeeded by another disproportionate system which seeks to load the Liability for the Value at Risk of the entire Network onto the Balance Sheets of all users.
This solution is set against a still undefined risk, with scant evidence of any assets actually being stranded – at least to this point in time.

The stated goals of the measures appear to be:

For Pre-Commissioning Generators -
To deter risky projects which may result in Network assets being built with no power station(s) to connect.
For Post –Commissioning Generators –
To ensure that sufficient warning is given to National Grid of closure or significant reduction of TEC. This in turn giving rise to wasted assets built to accommodate new generation, which would not have been built if it were known that capacity of existing generation, was reducing.

Whilst it may be argued that each type of user (Pre and Post) poses a risk of stranded assets the nature of the risk is different. For Pre-Commissioning generators the risk is inherent in the nature of the project and to some extent in the financial strength of the company behind it.

For Post-Commissioning generators the nature of the risk is that through age of the plant, or the uneconomic cost of continuing to run (e.g. fuel costs, transport), or the result of changing European or UK regulation that the plant closes without signalling its intent more than 4 years in advance. This is the time taken for National Grid to build typical network reinforcement.

Developing an Enduring Solution

The stated 'Broad Dimensions'

1) The extent of assets protected by user commitment

2) The extent to which the level of protection is adjusted to take account of the specific risks of the investment and/or generation project

Conditions suggested in the Ofgem letter.

a) Risk balance and Risk Profile of relevant generator assets.
b) Options to better reflect the generator circumstances do not necessarily have to increase the stranding risk, which may be borne by consumers.

1) The extent of assets protected by user commitment

National Grid in its CUSC Modification Proposal (CMP 192) has attempted to describe the extent of the assets in terms of Value at Risk – discounted with various factors including:
'Compliance'- where assets must be built to bring part of the system in to compliance and where a number of generators could leave the system and still require assets to be built (e.g. Cheviot boundary)
'Asset re-use' – where assets could be physically moved and used elsewhere (Note- no discount has been suggested where another generator or generators subsequently use the asset in situ).
Sharing with consumers ('Wider' assets only) 50/50 split
Sharing with Pre-Commissioning users and TO strategic investment ('Local assets).

National Grid has also proposed to class assets as either 'Wider' or 'Local' – in line with current definitions in the CUSC and charging methodology.
NGET proposes to treat these classes of assets differently: -

- Post-Commissioning generators will be exposed to only 'Wider' assets
- Pre-Commissioning generators will be exposed to both 'Local' and 'Wider'
- 'Wider' assets will be subject to a 50/50 split with demand (consumer)
- 'Local' assets will be 100% generator exposure though may be subject to a discount for sharing with other Pre-Commissioning generators or for, undefined, TO strategic investment and asset reuse.

In our view NGET has based its definition of assets and extent very much on the existing network and very little on the shape of the grid which will be built in the next 10 – 20 years. Much of the building of the network to connect renewables will be termed 'Local' and some of these assets will be very extensive indeed. Even under the new system as proposed in CMP 192 generators faced with the liabilities and securities – unrelieved by a share with demand – would still face huge and potentially volatile liabilities and securities.

So far the both the old systems of User Commitment and that currently proposed take no consideration of the strategic value of network assets built to connect energy sources rather than as project flagged up by individual developers. In our view this is a mistake and fails to value a sustainable fuel source as a factor to reduce rather than increase long term financial exposure to consumers. Developers may fail but the energy resource remains – therefore diminishing the likelihood of network assets being ultimately stranded.

A fair Enduring Solution should seek to reflect the true level of risk in 'Local' works and balance this with the strategic importance of 'Local' assets to the long term development of the Grid and to work toward the relevant Energy Networks directives of the EU and the UK's treaty obligations.
Any proposal should, therefore, redefine 'Local' assets more in line with strategic value and certainly should allow, at least, a 50/50 split (as is the case with 'Wider') with demand. Sustainability will help future consumers, as will competition through diverse fuel sources.

It would be tempting to codify only the connections in the easily defined and existing grid and to leave the more difficult and ultimately far more extensive and diverse Network to ad-hoc arrangements based on individual decisions between Ofgem, DECC and NGET. The result would be confusion for investors with very little transparency or predictability in those areas of Network growth whilst those with conventional plant within the existing Network may feel that they may be at risk of cross subsidising those whom they may see as being exceptions to the rule.

2) The extent to which the level of protection is adjusted to take account of the specific risks of the investment and/or generation project

NGET has, in CMP 192, put forward a 'Strawman' indicating how the securities demanded of users may be given some relief in line with a factors which may reduce the risk posed by developing projects or existing plant.
For Pre-Commissioning the Company has analysed past behaviour of developing projects and has identified a figure of 25% pre-planning consents and 3% post consents who subsequently either terminated or reduced TEC.
For Post –Commissioning the Company has done some work on the statistical predictability of closure based on power plant type and age. A reduced level of security is mooted based on - lowest for new plant and where the price of the resource is unlikely to be volatile and highest for plant nearing the end of its working life and with volatile fuel prices.

This partial relief is welcome and fully justified in that it seeks to go some way to linking the burdens placed on Pre-Commissioning generators with something approaching the likely risk of stranding. When compared with the current system – especially Final Sums it would reduce the outlay of those companies, which have to provide securities in the form of cash in ESCROW or Letter of Credit. The provision of these securities is expensive and reduces the overall borrowing capacity of the developer at a time when its needs to drive the project are greatest.

For Post-Commissioning generators the proposal still aims to load liabilities on Post-Commissioning generators but with some relief of securities demanded. The demand for any securities will be seen against the current level of zero.

Concluding comments on the Enduring Solution

There seem to be, still, inherent and fundamental weaknesses in the argument for partial relief in the level of securities demanded whilst leaving the liabilities for the VAR of the Network (however it may be discounted) on to generators.
The potential for damaging effects on generators remains whilst liabilities are loaded onto them. If liabilities, not just security demanded, were subject to the discounts already mooted as justifiable for provision of security then the impact would significantly reduced. There would still be enough 'persuasion' to encourage warning from existing generators where operations 3 –4 years away could be predicted. For Pre-Commissioning generators, a real barrier to entry would be removed whilst giving sufficient signals to developers to avoid speculative activity.

No work has yet been produced which seeks to predict the real risk of stranded assets based on what has gone before, as a starting point. This seems strange given the importance placed on this by Ofgem and the potential for impact on the generator community.

If risk is indeed the only driver behind User Commitment then why has insurance not been considered as a model – given that is has been means of handling risk, universally, since the mid-18th century?

It is disappointing that the time initially allowed for the CMP 192 Working Group to conclude its work is relatively short – at least compared to the time spent on CAP 131, for instance. It is our belief that time and resources should be given for the group to consider properly modelled alternatives such as insurance. The impact of the present definition of 'Local' assets should also be identified prior to Working Group consultation if at all possible – otherwise the value of the consultation may be compromised.

Significant Code Review route

Ofgem has clearly flagged up that it wants to bring the industry and other stakeholders on-board the Enduring Solution for User Commitment. It is our view that the CMP process, properly resourced in time and funding, remains the best way to achieve this goal. The biggest challenge may be in the question asked not the solutions put forward and as such it is difficult to see that a SCR would fair any better.
If the CMP process fails, then it is hoped that any SCR would have sufficient scope to allow the basic premise, behind the reason for User Commitment, to be fully examined.

Yours sincerely,

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