Modification proposal:	**Connection and Use of System Code (CUSC): Limit increases to TNUoS tariffs to 20% in any one year (CMP207)**		
Decision:	The Authority directs that CMP207 not be made[1]		
Target audience:	National Grid Electricity Transmission plc (NGET), all transmission system users, parties to the CUSC and all other interested parties		
Date of publication:	21 January 2013	Implementation Date:	n/a

Background to the modification proposal

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) charges[2] calculated and levied by National Grid Electricity Transmission plc (NGET)[3].

In accordance with these provisions, NGET has developed a TNUoS charge setting process that seeks to calculate and fix TNUoS tariff levels at a single value for the full financial year. This process requires estimates and forecasts to be made of certain factors.

Under the current TNUoS methodology ("the Methodology"), NGET uses annual TNUoS charges to seek to recover the total forecast annual revenue that licensees can earn for providing transmission capability at different locations[4]. Any differences between the forecast revenue level notified by licensees to NGET and the actual allowed revenues determined by their licences will produce a shortfall or surplus in annual revenue collected by NGET through TNUoS charges. This leads to consequential changes to TNUoS tariffs applicable to all generation and demand users in the following financial year[5]. The current regulatory framework seeks to direct the relevant licensees towards providing accurate forecast revenue information to NGET[6].

There are also other factors that affect the ability of users to predict movements in annual tariff levels in advance of the next financial year. These include –

(i) changes in the configuration of the transmission network (i.e. changes in the configuration of generation at different locations and to patterns of demand),
(ii) entry and exit by users of the network, and
(iii) changes to the Methodology.

Suppliers also have to set retail charges in advance of price changes (especially for fixed deals) and therefore have to make forecasts of future charges before they are confirmed by NGET.

The Methodology does not currently seek to directly mitigate the impact of movements in the factors above and their impact on TNUoS tariffs from year to year.

The modification proposal

Haven Power Limited (the proposer) raised CMP207 in March 2012, with the aim of improving competition in the supply of electricity by reducing the volatility and improving the predictability of the TNUoS tariffs levied on electricity suppliers. CMP207 proposes to restrict annual changes in demand TNUoS tariffs by introducing a percentage cap and floor.

CMP207 would modify the Methodology to restrict annual changes in demand TNUoS tariffs, with any deferred revenue (shortfall or surplus in the funds collected by NGET within any financial year) rolling over into that charging zone's tariffs for the following financial year. Any unrecovered revenue resulting from the application of a restriction on TNUoS tariff levels would be collected from all suppliers in the appropriate zones in the following year through a commensurate increase (in the event of a shortfall) or decrease (in the event of a surplus) in

[1] This document is notice of the reasons for this decision pursuant to section 49A of the Electricity Act 1989.
[2] These are described in Section 14.28 of the CUSC.
[3] NGET levies these charges in its role as the System Operator for the national electricity transmission system.
[4] Onshore, the level of forecast maximum allowed revenue (MAR) is determined by the price control formula set by Ofgem. Offshore TO revenues are determined following a commercial tender process.
[5] Each licensee is incentivised to avoid significant under/over-recoveries in any financial year.
[6] For example, SO-TO Code Processes 13-1 and 14-1 requires each licensee to send NGET their best forecast of its revenue requirement for the next financial year by 1 November and a final forecast of annual revenue by 25 January.

the affected tariff level, until the amount is fully recovered. The key features of the original proposal are set out below -

- On a zonal basis, a 20 per cent cap and floor would apply to changes to annual zonal demand[7] tariffs (£/kW) and zonal energy consumption tariffs (p/kwh).
- The 20 per cent cap/floor applies only to the overall TNUoS tariff, i.e. the aggregate of the locational and residual demand TNUoS elements[8]. It would not apply to any generation TNUoS tariff elements.
- The proposal would apply to both increases and decreases in tariff levels.
- All users located in a demand zone that reaches the cap/floor would be subject to a tariff adjustment in the next financial year to recover (or pass back) the relevant revenue.
- The cap would apply to the difference between final zonal tariffs and the previous year's tariff levels[9].
- The proposal reflects the effect of RPI growth between years.
- Implementation would take effect from 1 April 2013.

The CUSC workgroup assessing CMP207 developed four alternative solutions to modify the Methodology and submitted these to us to consider alongside the original proposal. The key features of these proposals are summarised in the table below[10].

Table 1: comparison of options

<table>
<tr><th>Original</th><th>WACM1</th><th>WACM2</th><th>WACM3</th><th>WACM4</th></tr>
<tr><th>Zonal</th><td rowspan="4">Same as original</td><td rowspan="4">Same as original</td><td>Same as original</td><td>Same as original</td></tr>
<tr><th>Percentage cap (20%) after taking account of RPI growth</th><td>Absolute limit on annual TNUoS tariff change[11]</td><td>Same as WACM3</td></tr>
<tr><th>Increases and decreases</th><td rowspan="2">Same as original</td><td rowspan="2">Same as original</td></tr>
<tr><th>Cap applies at zonal level</th></tr>
<tr><th>Year on Year (difference between final tariffs)</th><td>Difference between final tariff and the fifteen month ahead forecast (e.g. forecast of 2014/15 tariffs would be published in January 2013)</td><td>Difference between the final tariff and the twelve month ahead forecast (e.g. forecast of 2014/15 annual tariffs would be published in April 2013)</td><td>Same as WACM1</td><td>Same as WACM2</td></tr>
<tr><th>Demand only</th><td rowspan="2">Same as original</td><td rowspan="2">Same as original</td><td rowspan="2">Same as original</td><td rowspan="2">Same as original</td></tr>
<tr><th>Total TNUoS tariff</th></tr>
</table>

Of the alternative proposals, two members of the Workgroup considered that WACMs 1 and 3 better meet the relevant objectives of the CUSC for the Methodology[12] ("the relevant objectives") relative to the baseline. A majority of the Workgroup members (five) considered that the baseline was better than any of the proposed modifications. The proposer's view was that the CMP207 original better facilitated the relevant objectives compared with the baseline.

The Workgroup noted that changes to the electricity transmission licence would need to be made to take account of NGET's cost of financing any over/under recoveries of revenue due to charge restrictions under the original proposal. It was also recognised that additional changes

[7] Zonal demand boundaries are fixed.
[8] The combination of both these elements forms the total TNUoS tariff levied on both demand and generation users.
[9] For example, if NGET calculated a zonal demand tariff to be £1/kW in 2013/14 then the tariff in the following year (2014/15) could be anywhere between £0.8/kW and £1.2/kW without breaching a 20 per cent limit. In some zones a percentage cap/floor could therefore be reached where the absolute value of a change in the tariff is relatively low.
[10] Full details of all the proposed solutions are available in the Report - available from NGET's website.
[11] The absolute limit would be equal to 20% of the average zonal tariff change, weighted by zonal demand. For example, if NGET calculated the weighted average change in zonal tariffs was £5/kW then the cap and floor for each zonal tariff would be the forecast tariff plus or minus £1 (i.e. 20% of the weighted average change).
[12] Set out in SLC C5 (5) of NGET's electricity transmission licence.

to the licence would be needed to ensure that NGET was not penalised where a charge restriction led to them over recovering revenues.

CUSC Panel recommendation

The Panel voted on CMP207 at its meeting on 30 November 2012. The votes of the majority of Panel members indicate that neither the original proposal nor any of the WACMs better meet the relevant charging objectives and so should not be implemented. A minority of Panel members supported either of WACMs 1 and 3 as better meeting the relevant objectives. The full views of Panel members appear in the Report.

The Authority's decision

We have considered the issues raised by the proposal as described in the Report. We have considered and taken into account the responses to the Code Administrator consultation attached to the Report. In terms of the proposals we have concluded that:

1. on balance, the original proposal would not better facilitate the achievement of the relevant objectives;
2. it has not been demonstrated that any of the WACMs better achieve the relevant objectives; and
3. directing that the modification should not be made is consistent with our principal objective and statutory duties[13].

We therefore direct that CMP207 not be made.

Reasons for the Authority's decision

In making our decision, we have considered the views of the proposer, Panel members and consultation respondents.

In our view, the original proposal and all the WACMs would better achieve relevant objective (a), would not better achieve relevant objective (b) and are neutral in respect of relevant objective (c).

In respect of the original proposal, we consider that improvements in respect of relevant objective (a) are outweighed by negative effects on relevant objective (b). In respect of the WACMs we consider that the Report provided insufficient analysis of the extent of the benefits and the balance between the benefits in respect of relevant objective (a) and the negative cost impact in respect of relevant objective (b). We are in this case unable to say whether any of the WACMs better achieve these relevant objectives taken as a whole and we are therefore unable to direct the implementation of the proposal.

We set out below our assessment against relevant objectives (a) and (b).

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'

We consider the solutions presented in the Report could facilitate competition by lowering the costs of entry for suppliers. Restricting annual changes in demand TNUoS tariffs would provide additional certainty to suppliers and reduce the cash flow risks that they are exposed to and ultimately pass on to consumers. We expect this to reduce the cost of entry for new suppliers and allow some types of suppliers to compete more evenly (e.g. those with a less diversified customer base).

[13] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed in the Gas Act 1986, the Electricity Act 1989 and the Utilities Act 2000, all as amended.

We therefore consider that the original proposal and all the WACMs better achieve this objective relative to the baseline.

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)'

We consider that by deferring charges the proposals would weaken the cost reflective signal relative to the baseline. This will be particularly significant for the original proposal. Capping charge changes based on a percentage of last year's tariff means that low charges may become 'trapped', e.g. if the tariff in a zone is low, it is possible that (even small) changes will always breach the cap, which could result in the deferral running over into subsequent financial years. We think this would reduce the cost reflectivity of charges in the short to medium term relative to the baseline.

The risk of "trapping" as described above is removed under the WACMs due to the use of forecast data in the application of any restriction on TNUoS charges. Although we still consider that by deferring charges the cost reflective signal will be weakened under all the WACMs, we expect that in general this impact is unlikely to be significant. This is because variations in charges will be temporary, and demand customers have a limited ability to react quickly to these temporary changes. However, we do consider that there may still be significant impact on cost reflectivity for customers that move into or out of a charging zone after charges have been capped.

Recovering deferred transmission revenue by adjusting TNUoS tariffs in the following financial year by zone means that those customers that move into a zone the year after charges have been restricted will be subject to deferred charges but will not have benefited from the restriction in the previous year. Conversely, customers that move out of a charging zone the year after restrictions will avoid the deferred charges. While deferred charges will be one off in nature, those customers that are notionally over charged will not be reimbursed and vice versa. There would be similar impact when customers change their consumption patterns between years in which these charge restrictions apply. In our view this results in less cost reflective charges for these customers.

The Workgroup's analysis is not sufficient to assess the likely extent of under or over charging for individual customers. We note, however, that one case was identified by the Workgroup where final charges were 45% greater than the forecast charge. This would have resulted in around 25% of revenue in the relevant charging zone being deferred until the next year, which suggests that the impact could be significant for individual customers. While, again, we do not consider that this will have a major impact on the long term signal given by TNUoS charges, we consider that this variation in treatment is likely to be a material issue in terms of equity for the individual customers involved. We therefore do not consider that the original proposal and the WACMs presented better facilitate this objective for similar reasons to the majority of the Panel.

Cost reflectivity could also be weakened if any shortfall or surplus revenue from a charge restriction triggers penal interest rates applying to under and over recoveries under Special Condition (SC) D2 ('Restriction on Transmission Network Revenue') of the electricity transmission licence. In the absence of any changes to this condition, the proposals could lead to insufficient revenue being recovered compared to a more cost reflective approach that takes into account the cost of moving revenues between years.

Assessment having regard to the Authority's statutory objectives and duties

The effect of CMP207 on TNUoS charges will depend on a number of factors including the extent to which competition in the supply of electricity is improved and the effect of shifting risk from suppliers to the licensees. As discussed above it is our view that CMP207 would have a positive impact on competition although the extent to which this would be the case is unclear. The effect of shifting risk from suppliers and customers to the licensees is also unclear from the analysis set out in the Report. In particular, it does not assess what method would be needed to appropriately compensate licensees for this risk and what the cost of this might be. The overall impact on end costs for consumers is uncertain. We therefore consider that rejecting CMP207 is consistent with our statutory duties.

Further thoughts

We acknowledge that, as a general principle, the industry would like as much clarity and prior warning of changing tariffs and that this can bring benefits to consumers. We encourage industry to consider these issues going forward. We support this aim and also agree that the increased provision of forecast TNUoS data is helpful in addressing issues of predictability.

We note that the measures to increase the visibility of the latest view of forecast TNUoS tariffs were recently agreed as part of CMP206[14] *'Requirement for NGET to provide and update year ahead TNUoS forecasts'* (and implemented from 3 December 2012).

We also note that SC D2(1) requires licensees to use their best endeavours to recover their maximum allowed revenue in the relevant financial year, and SC D2(2) penalises licensees where they under/over recover outside the specified band around the target allowed revenue. Implementation of CMP207 under the current licence could result in licensees being unfairly penalised where charge restrictions affect the accuracy of their cost recovery.

We understand that, in the Workgroup's view, if CMP207 is approved, changes to the licence would need to be made (a) to ensure licensees are not penalised due to charge restrictions resulting from CMP207, and (b) to make clear that best endeavours are to be considered within the confines of any restrictions placed on the licensees. We think that any changes in this area should first therefore be made by licence changes followed by any consequential CUSC changes.

For the reasons set out in this letter, we consider that the CMP207 original or alternative proposed solutions should not be made.

Andrew Burgess

Associate Partner, Transmission and Distribution Policy
Signed on behalf of the Authority and authorised for that purpose

[14] The CMP206 report is available here: http://www.nationalgrid.com/NR/rdonlyres/AE88E99A-9427-4018-A0B6-E2B614DA6AB3/57562/CMP206FinalModificationReport10.pdf