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Dear Alena,

**Impact assessment on CMP201 - proposal to remove balancing charges from generators**

Thank you for the opportunity to respond to the Authority's Impact Assessment on CMP201 "Proposal to Remove Balancing Charges from Generators" published on 8<sup>th</sup> November 2013.

**Introduction**

We have serious reservations about the Authority's 'minded-to' position to not approve CMP201 as it appears to be in clear contravention of the EU legal requirements as enunciated in the Third Package<sup>1</sup>.

According to a recent UK Government legal review<sup>2</sup> of EU energy law:-

*"All of the measures in the Third Energy Package have the common aim of further liberalising the energy markets of the Member States, making national energy markets*

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<sup>1</sup> The term "Third Package" refers to Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC ("Electricity Directive"); 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 ("Electricity Regulation"); Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC ("Gas Directive"); Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 ("Gas Regulation"); and Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators.

<sup>2</sup> Further details on this review etc., are contained in Appendix 2.

*more transparent, both for businesses and consumers, and reducing disparities between such markets so as to make cross border access easier.”*

In our view CMP201 clearly meets the common aim of the Third Package, as outlined above, and especially with respect to “...*reducing disparities between such markets so as to make cross border access easier*”.

It appears, on the face of it, that the Authority is ignoring their wider statutory duties by not taking account of the wider benefits to consumers across all EU Member States, including the UK / GB. Not meeting the requirements of the Third Package could have serious consequences for the UK and the Authority.

This would be a very regrettable state of affairs and, therefore, we would strongly urge the Authority to (i) reconsider its ‘minded-to’ position and (ii) approve CMP201.

The Impact Assessment recognises that removing BSUoS costs from GB generators will result in greater market integration and benefits for the Internal Market but it expresses concern that this may increase wholesale costs in GB as a result of increased exports (from GB) resulting in costs which go up to GB consumers. However, this current situation is a result of the current relative plant mix and fuel costs in the relevant markets and by the time that CMP201 is implemented (which we suggest is 1<sup>st</sup> April 2017 at the earliest), could be significantly different if, for example, the Carbon Price Floor was removed; i.e. GB could be a net exporter and CMP201 would make no difference to GB costs. In addition, the National Grid modelling is recognised as providing a ‘direction of travel’ rather than an actual representation of the impact on consumers from implementing CMP201. Therefore the Authority’s potential rejection of the modification on this basis would appear fundamentally weak.

Furthermore, there are a number of additional matters for the Authority to be mindful of in making their decision on CMP201; namely:-

- (i) it is just coincidence at this point in time that by taking away the BSUoS charge paid by GB generators that GB would export more to the rest Europe and hence the GB market price could go up – conversely if GB were already exporting more it would make no difference to GB prices;
- (ii) anything (and not just CMP201) that results in lower generation costs in GB and hence leads to more exports from GB to the rest of Europe (which would be a better Internal Market outcome) would also result in an increase to the GB wholesale price; and
- (iii) GB can’t stop making changes to the GB industry arrangements for changes that may or may not happen in Europe.

We have answered the five questions posed in the consultation, and these are contained in the Appendix 1 to this letter. However, we have some additional observations on various parts of the Impact Assessment and we outline these below.

## **Observations**

### **Executive Summary (Impact Assessment pages 4-5)**

*“The proposal is intended to level the playing field between generators based in GB and elsewhere in Europe.”*

A very important aspect of Third Package is the creation (and long term sustainability) of the Internal Market in electricity and CMP201 clearly supports the achievement of that. It clearly follows, and this is backed up by the work undertaken as part of CMP201, that not implementing CMP201 will run directly counter to the aims and objectives of the Third Package.

*“Since BSUoS charges are ultimately passed through<sup>5</sup> to the consumer (whether suppliers or generators pay them), this change of itself should have no impact on consumers.”*

This is an important point and one that we agree with. As a result of CMP201 being approved we would expect market forces to apply resulting in a corresponding reduction in (GB) wholesale prices, charged from generation to suppliers, equivalent to the reduction in BSUoS costs (and associated risk premium) that generators currently apply to their market prices. Therefore, as a result of this change per se, there should (in our view) be no impact on consumers.

However, the Impact Assessment goes on to outline in the same paragraph that “....the reduction in a generators wholesale price increases demand from Europe and this in turn increases net export from GB to Europe across the interconnectors.”

We agree this may well be the outcome, but this outcome is a consequence of the creation and continued application of the Internal Market in electricity. It would equally be correct to assert (but we would not advocate this as a policy) that if there were to be no exports permitted from GB then if CMP201 were approved there would be no impact on GB consumer costs.

*“Consumers in the rest of Europe may, on the other hand, benefit from lower wholesale prices as they will be able to switch to importing cheaper electricity from GB.”*

This is an important point that the Authority appears to have overlooked. We have been attending numerous meetings over the past 18 months or so associated with the development of the suite of European Network Codes. A key aspect associated with those codes is that where a change leads to wider ‘societal benefits’ that it should be made even where the cost(s) fall on only one class of parties (such as generators) or a collection of parties in one, or more, Member State.

*“We recognise that when considered in isolation, removing BSUoS charges from generators should promote more efficient trade between GB and European interconnected markets.”*

This too is an important point that must be given due weighting by the Authority in its decision making. The promotion of cross border trade (and, equally, the avoidance of the distortion of cross border trade) is an important aspect of the Third Package that, in our view, the Authority should be very mindful of.

We note that the following sentence in the Impact Assessment states:-

*“However, there are significant uncertainties in the European market that could affect the benefits of this proposal, such as the outcome of a decision on market splitting and the future progression of the EU tariffication workstream.”*

Yes this is indeed the case. However, much of the deliberations on these items of uncertainty involve the active engagement by ACER of which the Authority is a key participant.

Furthermore, and perhaps more importantly, if this argument were to be used in the final decision on CMP201 then it would appear to be a recipe for doing no future GB code changes as there will, invariably, be a series of externalities that could (either in isolation or collectively) have an impact on the GB code change being considered at the time.

In this regard, it has always been our understanding that any GB code change should be assessed against the ‘baseline’ which is (in this case) the CUSC as it exists today without account being taken of any potential, but as yet not actual, other changes. This was reinforced by the Authority’s decision to reject (BSC) modification P111<sup>3</sup>.

It being clear that contingent modifications cannot be raised by GB code parties it would be perverse for the Authority to reject a GB code modification on the basis of a contingent change to other legal / regulatory etc., documents which have not, as yet been either raised let alone approved or implemented.

If the Authority were to adopt this approach (of rejecting duly constituted GB code modifications on the basis of a potential future, as yet undefined, change) this would be a bizarre situation and could lead to perverse and unreasonable outcomes in the future.

Finally, in seeking to take account of the ongoing developments in Europe it seems bizarre to us that the Authority appears to have ignored (in this respect) the ongoing substantial (and detailed) developments of the Target Model and the associated European Network Codes for, amongst other things, Balancing, Forward Capacity Allocation, Capacity Allocation & Congestion Management and Load Frequency Control & Reserve all of which seek to encourage (and support) cross border trading, by generators and others, of energy and associated services. Such developments could, from the perspective of GB generators, be substantially undermined if costs (such as BSUoS) faced by them were not also faced by their direct competitors in the Internal Market.

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<sup>3</sup> [http://www.elexon.co.uk/wp-content/uploads/2012/02/p111\\_ofgem\\_decision.pdf](http://www.elexon.co.uk/wp-content/uploads/2012/02/p111_ofgem_decision.pdf)

*“Making this change will also result in the significant cost to all GB consumers noted above.”*

On an initial examination we can see why the Authority might come to this view. However, it is important to be mindful of the Workgroup’s assessment of this matter, as summarised in paragraph 4.37 of their report, namely:-

*“It was surmised that end users within Great Britain could initially be adversely impacted by around £177m out of a total GB model cost of approximately £16,000m equating to a 1.1% rise per annum in GB market costs. The results however need to be considered in the context of an idealised and simplified market model, the accuracy of the underlying sample data and the assumption that no other market effects, other than the change in the BSUoS arrangements occur.”*

Whilst the amount involved, in £ terms, is large at £177M it is, when considered in the context of the overall total GB model costs of ~ £16B, in the region of 1.1% which, in the context of the very simple model used to assess this CMP201 change, is well within the realm of normal modelling assumptions and errors; i.e. a slight variation of one or more of the assumptions used could have a similar or greater positive or negative effect of 1.1% (or £177M).

Notwithstanding that, the Authority (in its Impact Assessment) appears not to have taken account of the corresponding reduction in GB consumer costs that would arise from the increase in competition (in the GB generation market) arising from the new generation encouraged to locate here as a result of this CMP201 change being put into effect.

It is for these reasons that we believe (a) that the impact on GB consumers of implementing CMP201 cannot be considered significant with any degree of confidence and (b) that those impacts will, in no small part, be offset to some extent by the increases in competition in the GB generation market arising from new generators entering the market.

## **Chapter 1 (Impact Assessment pages 6-10)**

*“1.7 ....In December 2011, NGET raised a CUSC modification proposal to remove BSUoS charges from interconnector flows (CMP202).”*

and

*“1.10 .....In our European trading partner countries, it is more common for the equivalent balancing costs (covered by BSUoS in GB) to be paid largely by suppliers rather than generators.”*

It is important to recognise that as a result of the Authority approving CMP202 (the ‘sister’ modification to CMP201, which removed BSUoS charges from interconnector parties) that a generator located out with GB will not face either balancing costs in their own country or, when exporting into GB, those balancing costs in GB. Conversely a GB generator either seeking only to sell into the GB market, or to sell

into non GB market(s), will face the (GB) balancing costs. This grossly distorts the Internal Market in electricity by giving generators outside GB a cost advantage compared to generators within GB who, absent the CMP201 change, pay those costs.

In other words without CMP201 being implemented the GB wholesale market will receive ‘cheap’ imports from the rest of Europe (distorting GB market prices and competition) whilst the non GB wholesale market(s) will be denied cheaper (GB) electricity imports (distorting those market prices and competition in those markets).

We concur with the Impact Assessment’s simplified example (shown in Figure 1 plus para 1.14) that without CMP201 “...a GB generator is placed at a competitive disadvantage by the application of BSUoS charges”.

This, in our view, is a gross unfairness that CMP201 seeks (correctly) to rectify.

*“1.16. NGET raised CMP201 as a means of aligning this particular aspect of the GB charging methodology with the arrangements prevalent in other EU countries. The proposer (NGET) considered that the removal of balancing charges from GB generators would address this inconsistency and create a more level playing field for competition between GB and European generators.”*

We commend National Grid for correctly identifying that the removal of balancing charges from GB generators would address the inconsistency that arises (with the approval by the Authority of its ‘sister’ modification CMP202) that non GB generators are exempt from paying GB BSUoS and that, furthermore, CMP201 corrects this defect and creates a more level playing field for competition between GB and European generators.

## **Chapter 2 (Impact Assessment pages 11-12)**

*“2.2....This is intended to align the GB arrangements with the prevalent approach in the rest of Europe, where generation is generally not liable for balancing charges. All parties would still be liable for charges relating to their own imbalance.”*

It is important to recognise that CMP201 is a logical, practical and equitable Modification that seeks to ensure, as we progress towards the Internal Market in electricity (which has been endorsed by both the UK Government and Parliament when the Third Package was given effect, on 10 November 2011, in UK law by the Electricity and Gas (Internal Markets) Regulations 2011<sup>4</sup>), that GB generators are not unduly and disproportionately discriminated against.

*“2.6 CMP201 implementation options were chosen to ensure that the transfer of 50% of the BSUoS charges from generators to suppliers was adequately reflected in pricing structures and contractual arrangements of both generators and suppliers. These were developed by the Workgroup (WG) to minimise the potential for windfall gains and losses amongst the industry participants affected by the change.”*

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<sup>4</sup> <http://www.legislation.gov.uk/ukxi/2011/2704/part/1/made>



It is important to recognise that phasing options for the implementation of CMP201 were considered by the Workgroup, as set out in their report (in particular paragraphs 4.101-4.108); however, it was determined that a single date, for implementation, should be adopted.

That being the case, as we have set out in our response to both the Workgroup and the Code Administrator consultations, it is our considered view that the market distortions which CMP201 seeks to address should be corrected at the earliest practical opportunity and, therefore CMP201 Original (rather than either of the two Alternatives) should be implemented. Delaying the implementation date of CMP201 will lead to the gross market distortion continuing beyond the time when it could (and should) have been rectified.

*“2.11. At the CUSC Panel meeting on 26 April 2013 a vote was taken on the CMP201 proposal and its alternatives. The Panel voted by majority that CMP201 (both the original and the alternatives) better met the Relevant objectives and that CMP201 should be implemented. A majority of the Panel expressed a preference for the original proposal (ie with the 2 year implementation period).”*

We agree with the majority of the Workgroup and the CUSC Panel that CMP201 better meets the applicable CUSC Objectives and that CMP201 should be implemented from 1<sup>st</sup> April 2017 (i.e. WACM1, if approved by the Authority prior to 31<sup>st</sup> March 2014, or the Original if approved after that date but prior to 31<sup>st</sup> March 2015).

### **Chapter 3 (Impact Assessment pages 13-20)**

See our answers to Questions 1-3 in Appendix 1.

### **Chapter 4 (Impact Assessment pages 21-28)**

See our answers to Questions 4-5 in Appendix 1.

### **Conclusions**

We have been mindful of a recent detailed independent study<sup>5</sup> undertaken into generator transmission charges across four countries in Europe<sup>6</sup> on the matter of harmonisation. The conclusions of that report are shown below with the word ‘transmission’ in the context of generator charges removed as, in our view, these conclusions (on generator transmission charges) are equally relevant for other generator costs (such as BSUoS).

*A lack of harmonisation or changes to generator charges which reduce harmonisation between countries for reasons other than to reflect differences in forward looking costs can have three different types of impact on economic welfare.*

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<sup>5</sup> The study has been provided to us in confidence. We shall provide the reference etc., to the Authority under separate cover (so that our letter can be published).

<sup>6</sup> France, Germany, Belgium and the Netherlands.

*First, they can result in distorted operational decisions. If a low cost generator in country A faces high charges, it may not produce electricity, with demand instead being satisfied by a higher cost generator in country B where charges are lower. This reduces economic welfare, because demand is not met using the lowest cost combination of resources.*

*Second, they can result in distorted investment decisions. If generator charges are high in country A, investors may opt to locate in country B and export power to country A. This would be inefficient if other aspects of cost (e.g. land, labour) were higher in country B.*

*Third, they may increase investors' perceptions of risk. If generation charges increase in country A for reasons unrelated to cost reflectivity and generators cannot pass through all of the cost increase, it will reduce returns on investment. Investors may take the view that the same or similar changes could take place in the future and will therefore demand a higher return on investment to compensate this regulatory risk. This will tend to reduce investment in the country's power sector, resulting in demand not being met in the most efficient way (e.g. overreliance on older, less efficient plant). It will also tend to result in under-consumption of electricity over time (e.g. through larger, more mobile customers locating in other markets).*

Mindful of the detailed reasoning we set out in this letter and the associated Appendices we believe that the Authority should (a) reconsider their 'minded-to' position and (b) approve the implementation of CMP201 from 1<sup>st</sup> April 2017<sup>7</sup>. We hope you find these comments helpful in your deliberations on the impact of CMP201.

Yours sincerely

Garth Graham  
Electricity Market Development Manager

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<sup>7</sup> i.e. WACM1, if approved by the Authority prior to 31<sup>st</sup> March 2014, or Original if approved after that date but prior to 31<sup>st</sup> March 2015.



## APPENDIX 1 – ANSWERS TO THE QUESTIONS POSED

### CHAPTER 3: Impact of CMP201

#### **Question 1: Do respondents consider that we have identified the relevant impacts of the CMP201 proposal?**

We note the statement in paragraph 3.2, namely that *“The quantitative effects of the proposal have been modelled by NGET. We have reviewed the model and underlying assumptions, which we consider reasonable.”* We concur with the Authority that the modelling and its underlying assumptions are reasonable.

Furthermore, we note the related statement that *“The modelling is limited to providing an indication of the likely effects, rather than a precise numerical impact.”*

By its very nature trying to comprehensively model three major energy markets; such as GB, France and Holland (especially, given the large volumes of interconnector capacity between France and Holland with the rest of continental Europe, and Germany in particular); would, for a CUSC Workgroup be impractical. Instead a far more pragmatic and reasonable approach has been to undertake some simple modelling to indicate the likely effects, in very broad terms, of CMP201. This, in our view, is appropriate in the circumstances, although it leads to results which are, in normal modelling terms, within the realms of the assumptions used and the model that has been constructed.

We note the comments in paragraph 3.5, namely that the impact of the CMP201 proposal has been considered from a GB perspective. Whilst we can see the merit in this, it is important to note that under its wider statutory duties, the Authority also needs to consider, as part of the GB perspective, the wider pan-European related matters and in particular those matters covered by the Third Package, such as the Internal Market.

Whilst it may be the case that as a result of selling their power into non-GB markets that the GB market cost increases, in the short term, as more is exported out of GB, it's equally important to recognise, as a result of such an increase, that more generation will be attracted to locate in the GB market which, in turn, should lead to downward pressure on wholesale prices, leading to lower overall costs for GB (and non-GB) consumers.

We recognise the near term impact that CMP201 could potentially have on GB suppliers, such as that noted in paragraph 3.6 (point 1):-

*“Suppliers may be locked into existing contractual arrangements, preventing them from passing through the BSUoS cost to consumers.”*

We are mindful that consumer contracts are being offered and accepted in the GB marketplace up to early 2017 and therefore it seems appropriate, in the light of this, to consider applying CMP201 from 1<sup>st</sup> April 2017 (i.e. WACM1, if approved by the

Authority prior to 31<sup>st</sup> March 2014, or Original if approved after that date but prior to 31<sup>st</sup> March 2015).

However, we are also mindful that little evidence of fixed prices beyond this date have been forthcoming or that such contracts would, materially, be affected by this change given that GB wholesale prices do not extend that far out. Furthermore, notwithstanding this CMP201 change there are a host of other changes, such as the introduction of the CfD regime in GB and the application of the suite of European Network Codes, together with the introduction of the 'Target Model', which could have a far greater effect on GB supplier cost (be that positive or negative) than that which may, possibly, arise from the implementation of CMP201.

We note the comment in paragraph 3.6 (bullet 2):-

*"...by transferring BSUoS costs to suppliers, who are less able to access constraint revenues..."*

Whilst this may indeed be the case it could equally be the case that as a result of this change that suppliers are appropriately incentivised to provide balancing services themselves, such as through the widely anticipated 'demand side response' or indeed via the new 'Demand Side Balancing Reserve' service which the Authority approved. Given this we believe the effect of the BSUoS cost transfer (if it exists at all) could largely, if not wholly, be mitigated by suppliers.

We concur with the statement expressed in paragraph 3.8 that:-

*"Removing BSUoS costs from GB generators should improve the efficiency of trade in the EU as a whole; GB generators would be able to compete on a more level playing field relative to generators based in mainland Europe."*

As we have outlined elsewhere in this response this is a key aspect for the Authority to be mindful of when coming to a decision on CMP201.

We appreciate that the Impact Assessment then goes on to say:- ,

*"However, ... we have concerns that uncertainties and distortions could impact on this benefit being realised."*

For the reasons we outline elsewhere in this letter it is equally the case that there are (far greater?) 'uncertainties and distortions' that could impact on GB suppliers (and GB generators) from, for example, the introduction of the CfD regime in GB and the application of the suite of European Network Codes, together with the introduction of the 'Target Model'. Thus even if CMP201 were (notwithstanding our comments to the contrary) not to be implemented there could still be detrimental impacts on the 'benefits' from not doing this change – the 'benefits' presumably being ~£177M?

In terms of the longer term impact noted in paragraph 3.9 that:-

*“....in the worst case scenario, no such offsetting investment occurs, consumers’ bills would remain higher in each and every year following the implementation of this proposal.”*

We are mindful that the overall aim of the UK Government’s EMR proposals are designed to encourage and support the continued development of generation in GB over the medium term and therefore we feel that the likelihood of this ‘worst case’ coming to fruition are very slim.

We note the National Grid model variables set out in Figure 2 of the Impact Assessment. These, in our view, are appropriate in the circumstances.

We concur with the statement, in paragraph 3.12, that:-

*“The purpose [of the National Grid modelling] was to give a better indication of the direction and scale of the potential impact, rather than to dynamically model the impact on the market over time. For this proposal, the latter was seen as too complex, relied on too many uncertain assumptions and it was unclear it would have additional benefits. ”*

It is, in our view, important for the Authority to be mindful of this important caveat that applies to the National Grid modelling of the potential effects of CMP201.

In our view this important ‘health warning’ about the modelling results needs to be heeded. What the model does indicate (but neither predicts nor forecasts) is the ‘direction of travel’ that would be expected from CMP201, and that direction is, in our view, positive overall for consumers across Europe (including, therefore, GB).

The sensitivity of the National Grid modelling is perhaps best illustrated in the example noted in paragraph 3.13, namely that:-

*“NGET showed that the results of the model are sensitive to changes in the assumptions of the merit order. That is, impacts will differ depending on reducing the price of coal relative to gas. ....The change to fuel costs has a large impact, due to the interaction of its impact on the GB merit order relative to those in France and Netherlands – the latter are more coal dominated.”*

Thus even a relatively small change in the demand, say, for either coal or gas in France or the Netherlands over the period prior to CMP201 being implemented could see the purported GB impact of ~£177M (from CMP201) being, perhaps, partially or wholly negated by these changes in fuel prices (which could reasonably be considered to have a far greater effect on wholesale market prices in GB and the rest of the EU than this CMP201 ever would).

In terms of the possibility of the potential impact (of CMP201) lasting over the longer term, as suggested in paragraph 3.16 (“...consumer bills will remain £2-£2.50 higher in every year following the implementation of the proposal”) we believe this to be highly unlikely (a) because of competitive pressures leading to generation locating in the GB market in response to the appropriate price signals and (b) the UK

Government's EMR proposals, which support the ongoing development of more generation in GB over the medium and long term.

We note the reference to RCRC in paragraphs 3.29-3.39 and welcome the raising, by National Grid, of a 'sister' (BSC) Modification P286 which would address the concerns around possible inconsistency in treatment (if CMP201 were approved). We concur with the Authority's 'minded-to' position that *"If we were to approve CMP201 we would also likely approve P286."*

**Question 2: Do respondents have any quantitative or qualitative evidence on the likelihood of additional investment in generation that would offset the relative increase in wholesale prices?**

We believe, for the reasons outlined elsewhere in this response that as a result of competitive market forces that generation will respond to the market signals arising from (a) the implementation of CMP201, (b) the UK Government's EMR proposals and (c) other initiatives (such as the Authority's approval of the Strategic Balancing Reserve and Demand Side Balancing Reserve) such that the likelihood of additional investment in GB generation (i) would occur and (ii) that this would offset the relative increase in wholesale prices (if they were to occur – we have some doubts) as a result of CMP201 being implemented.

**Question 3: Do respondents have any further evidence on the effect of CMP201 on supplier credit risk.**

We note this impact and in particular the two statements in paragraph 3.24:-

*"A direct consequence of CMP201 is increased BSUoS charges for suppliers. Increased financial payments may require suppliers to raise their credit holdings respectively."*

and

*"Smaller suppliers may find it more difficult to change their credit arrangements compared to larger ones – which may result in a negative impact on competition, owing to reduced competitiveness of the smaller suppliers."*

In terms of the first statement we are not certain that as a direct consequence of CMP201 being implemented that suppliers will see their BSUoS charges rise. If, taking a simple illustrative example, BSUoS is considered by a generator to be £1 in a particular period, that generator (currently) expects to pay 50% (i.e. 50p) as does the supplier (assuming both 'agree' that the expected BSUoS is £1 for the given period).

However, both the supplier and the generator then each apply a 'risk premium' to take account of the risk that their expectation of BSUoS being £1 is correct. If that is, say, 10% then it equates to 55p each (or £1.10p). The generator therefore factors in 55p to their wholesale price which is passed onto the supplier(s). But if, for example, the generator believes the risk is greater than 10% and is, say, 20% then this extra risk

premium is passed onto the supplier(s) in the form of a wholesale price that is 60p higher, rather than 55p, taking the overall cost paid by the supplier(s) to £1.15p.

However, if the supplier's 10% risk premium were to be applied (after CMP201 is implemented) by the supplier to 100% of the BSUoS cost then the cost to them would be £1.10p which is a saving, in this very simple illustrative example, of 5p.

In terms of the second statement, we can find no evidence to support the contention that smaller suppliers would be adversely affected by this proposed change. Indeed the evidence in the Final Modification Report, at paragraph 4.65, points to the opposite effect, namely that:-

*“National Grid reviewed the current holding of credit cover to quantify the extent of any credit cover changes. The results of this are summarised in Annex 10. This indicated that based on current levels of credit only four parties would be affected; none were a small Supplier.”*

Paragraph 4.65 (of the FMR) goes on to say that:-

*“Of those four Suppliers, one may acquire sufficient additional cover through the payment history mechanism in a few months. The four affected parties identified all related to companies of significant size, two of which provide Parent Company Guarantees leaving potentially only one Supplier required to increase their credit cover with National Grid (noting it may reduce in other areas). If CMP201 were implemented then, given the likely implementation timescales, any affected party would have sufficient time to arrange for sufficient credit cover.”*

Furthermore, as the Final Modification Report notes, at paragraph 4.61:-

*“....[the] overall credit risk to Suppliers would include a reduction of credit that they post in wholesales trades. This information is not available as it is largely a bilateral arrangement between Suppliers and Generators. This could largely net off the overall change to individual Suppliers requirement with National Grid – subject to an equal and opposite reduction in wholesale prices. The Workgroup noted that the analysis indicated the change was not exactly equal and opposite and would depend on the actual bilateral trading arrangements.”*

Therefore, in light of the above, we share the initial view of the Authority, as set out in paragraph 3.28 “....that CMP201 is likely to have a neutral impact on supplier credit risk” . We appreciate that supplier credit risk is, in general terms, a matter of concern; however, there are far greater risks (than CMP201) that suppliers may face, in terms of credit, from (for example) the introduction of the CfD regime in GB and the application of the suite of European Network Codes, together with the introduction of the ‘Target Model’.

## **CHAPTER 4: Initial Assessment**

### **Question 4: Do respondents agree with our initial assessment of the proposal?**



We have set out in our response to Questions 1-3 above a number of detailed reasons as to why CMP201 should be implemented. As such it therefore follows that we do not agree, overall, with the Authority's 'minded-to' position which arises from their initial assessment of the proposal.

Overall we believe, for the reasons detailed elsewhere in this response, that CMP201 would better achieve Applicable CUSC Objective (a) regarding competition.

We note the Authority concludes, according to paragraph 4.12, that:-

*"In light of the above, our initial view is that the impact of redistribution of costs from GB generators to GB suppliers on competition in our domestic electricity market is neutral."*

In our view the effect on competition in the domestic (GB) electricity market is positive and, furthermore, the effect on competition in the wider European electricity market is substantially positive.

In terms of the Authority's additional comments in respect of the effect on competition we concur with their statements in:-

Paragraph 4.7

*"Removing BSUoS costs from GB generators should improve the efficiency of trade in the EU, as import/export interconnector flows would closer reflect true differences in generation costs (since these are now on a more level playing field). In an open market, competition is increased if parties are able to trade on an equal basis, and higher profit margins should attract additional investment (provided no other barriers to entry exist). This proposal should therefore increase effective competition in generation."*

Paragraph 4.9

*"Our initial view is that the removal of the BSUoS charges from generation allows GB generators to compete on a more equal footing with European generators. This is because the prevalent approach in the rest of Europe is that generation is generally not liable for the recovery of BSUoS-equivalent costs through a specific charge."*

Paragraph 4.10

*"...[have] considered the impact of CMP201 on pumped storage, .... the impact should be broadly neutral. We agree with this view."*

Paragraph 4.11 (bullet 1)

*"...our initial view is that all of the proposed implementation timescales are such that any approval decision would permit sufficient time for the changes*



*to be adequately reflected in pricing structures and contractual arrangements.”*

Paragraph 4.11 (bullet 2)

*“Our initial view is that we do not consider there to be enough evidence that suppliers face more risk than generators.”*

Paragraph 4.11 (bullet 3)

*“If CMP201 were implemented then, given the likely implementation timescales, any affected party would have sufficient time to arrange for sufficient credit cover.”*

Paragraph 4.11 (bullet 4)

*“.....smaller generators would have reduced credit risk and therefore this could benefit competition.”*

Paragraph 4.13

*“Due to the increase in generator profit margins, we would expect there to be increased market entry or reduced closure relative to the current baseline....”*

Paragraph 4.15

*“.....our initial view is that we do not consider there is enough evidence that suppliers face more volatility than generators who would pass the risk to suppliers in the wholesale market. Further, the requirement for additional credit cover does not appear to affect suppliers to a great extent.”*

and

*“....we do not consider that this would create a barrier to entry for small suppliers.”*

Paragraph 4.17

*“CMP201 does not change the size or volatility of the BSUoS charge, nor is the new method of distribution adding complexity. As such our view is that this proposal will not impact the stability, complexity and predictability of the commercial and regulatory arrangements.”*

Overall we concur with the Authority’s assessment (in paragraphs 4.21-4.23) that CMP201 is neutral with respect to Applicable CUSC Objective (b) regarding cost reflectivity.

Overall we believe, for the reasons detailed elsewhere in this response, that CMP201 would better achieve Applicable CUSC Objective (c) regarding taking account of developments, especially from a pan-European perspective.

Therefore, on balance, against the Applicable CUSC Objectives that CMP201 (Original and WACMs 1 and 2) better achieve these objectives, although the benefits will start to diminish if the implementation date is delayed. In this respect we support the implementation of CMP201 on 1<sup>st</sup> April 2017 (i.e. WACM1, if approved by the Authority prior to 31<sup>st</sup> March 2014, or the Original if approved after that date but prior to 31<sup>st</sup> March 2015).

We now turn to the Authority's wider statutory duties, which we take in the order set out in paragraph 4.30, as follows.

#### The reduction of greenhouse gas emissions

We believe that the effect of CMP201 on greenhouse gas emissions will be positive as it will remove a bias against sitting generation in the country where the demand is located. It will also be positive, in terms of greenhouse gas emission reductions, in the medium and long term (noting that in the short term effects should be mitigated by the lead time to implementation) as low carbon generation, supported, for example, by the UK Government's EMR proposals come on-line.

#### Security of supply

In our view CMP201 should lead to additional generation locating in GB over and above that expected due to other measures; such as the UK Government's EMR proposals. This will be a positive effect on security of supply in GB.

#### Furthering competition

As we have detailed above in terms of Applicable CUSC Objective (a) there are strong arguments that show that CMP201 will further competition.

#### Consumer bill impacts

In our view, for the reasons we set out in this response, the National Grid modelling gives the broad 'direction of travel'. Equating that to an actual impact on individual consumers (as suggested, say, in paragraph 4.38) would appear to place too much weight on the simple modelling undertaken. Furthermore this effect is in the region of ~1.1% and as such is well within the realms of modelling accuracy; i.e. credible variances in, say, the coal or gas price in France and Holland could mean the effect, on GB consumers, of CMP201 is neutralised.

#### Impact on vulnerable and protected customers

We do not believe that CMP201 will have any additional material impacts on vulnerable and protected consumers.

#### European integration

In our view, as regards the Authority's wider statutory duties, this is the most pertinent, with respect to CMP201 and it is, to use a Latin phrase, 'primus inter pares' (first among equals).

We concur with the Authority's comments in paragraphs 4.40 and 4.41, namely that:-

*“Removing market distortions should facilitate correct signals for efficient investment decisions, which ultimately would be expected to benefit consumers across the EU, by reducing prices.”*

and

*“Therefore, removing BSUoS from generators to reflect the situation in EU trading partner countries where the equivalent charges are typically levied on suppliers only, should increase integration with the European electricity market and thereby ultimately lead to consumer benefits.”*

As we have noted repeatedly in this consultation response, there are a host of potential changes coming along which could have a far greater effect than CMP201. However, where these changes are unknown; such as ‘future tariffication’ and ‘the outcome of a decision on market splitting’ as noted in paragraph 4.42; we should not hold up the implementation of a known beneficial change like CMP201 as (a) these unknown changes may not, eventually, occur and (b) even if they do the nature of that change (at some time in the future) could be significantly different to what is being suggested today.

In terms of the comment, in paragraph 4.42 that “...BSUoS is only one of several existing distortions to European trade such as the carbon floor price or, for example, the Netherlands’ tax on some generators” it seems to us to be arguing that ‘two wrongs make a right’. We are not familiar with this particular piece of Dutch legislation but merely observe that if this argument were to hold sway it would presumably also be used by the Dutch tax authorities to argue to not change their distorting tax legislation (on the basis that in GB the distortion of generators paying 50% of BSUoS had not been removed either).

In conclusion, on this matter of European integration, for the reasons we have detailed elsewhere in this response we profoundly disagree with the Authority’s view as set out in paragraph 4.43 that “...whilst on a standalone basis, this proposal looks like it would increase European integration, we are not convinced, nor has any substantiating evidence been provided, that this proposal will actually fully realise the intended benefits of greater EU integration.”

#### Impact on health and safety

We, like the Authority, cannot identify any health and safety implications from CMP201.

#### Best regulatory practice

We note the comments in paragraph that:-

*“Although this proposal would progress along a path to a more integrated European market, it is not put forward in the context of a holistic appraisal of issues impacting efficient trade between EU member states.”*

We are not certain that it is within the vires of the CUSC to undertake ‘a holistic appraisal of issues impacting efficient trade between EU member states’.

However, we do note the timing associated with CMP201 being raised. As we understand it “[t]he Third Package legislation was introduced in Great Britain through the Statutory Instrument for the Electricity and Gas (Internal Markets) Regulations 2011 which came into effect on 10 November 2011. The Statutory

*Instrument fully transposes the Third Package into UK law. As a result of these changes, a number of changes were made to the gas and electricity licences, including National Grid's Electricity Transmission (NET) Licence.”<sup>8</sup>*

CMP201 “was proposed by National Grid Electricity Transmission plc (NET) and submitted to the CUSC Modifications Panel for their consideration on 8th December 2011.”<sup>9</sup> which was the earliest practical date for doing so.

As noted in the summary of CMP201 set out in the Final Modification Report:-

*“The EU “Third Package” aims to deliver all consumers greater choice with more cross-border trade so as to achieve efficiency gains, competitive prices and security of supply. It recognises that different market structures will exist however it also acknowledges the need for fair competition across the European Community so as to provide producers with the appropriate incentives for investing in new generation. Changing the GB arrangements as proposed in CMP201 thus facilitates the aims outlined in the EU Directive 2009/72/EC concerning rule for the internal market in electricity”.<sup>10</sup>*

In our view CMP201 seeks to correctly rectify, within the limitations of the CUSC vires, a clear defect, in the CUSC, that arose from the implementation in mid November 2011 of the ‘Third Package’ into UK law. The wider ‘holistic appraisal of issues impacting efficient trade between EU member states’ that the Authority refers to may well be warranted but, unfortunately, its not within the ability of a CUSC Party to seek such a ‘holistic appraisal’ via a CUSC Modification. What a CUSC Party can do is seek to rectify the CUSC defect and leave any wider ‘holistic appraisal’ to the appropriate bodies.

#### Risks and unintended consequences

We note the comments regarding constraint payments and do not agree with them as such an approach would seem to suggest making no future changes as they to might “...remove the option for us to make it cost reflective in future – i.e. reduced optionality”.

In conclusion, we believe that the Authority’s ‘minded-to’ position is flawed for the detailed reasons we set out elsewhere in this response and in particular with respect to complying with its statutory duties as regards applicable EU Law.

#### **Question 5: Are there other relevant factors that respondents consider we should take into account?**

We have detailed elsewhere in this consultation response all the relevant factors that we consider the Authority should take into account when making its decision on CMP201 and, therefore, we have nothing further to add in respect of this question.

<sup>8</sup> Opening paragraph of CMP225 <http://www.nationalgrid.com/NR/rdonlyres/EF94B052-58BC-4AA6-9A76-92DB9EA6353B/63237/CMP225ModificationProposal.pdf>

<sup>9</sup> Paragraph 1.3 of the CMP201 Final Modification Report.

<sup>10</sup> Ibid. paragraph 1.2.

## APPENDIX 2 – UK / EU ENERGY COMPETENCIES – THE THIRD PACKAGE

Extract from the UK Government's "Call for Evidence on the Government's Review of the Balance of Competences between the United Kingdom and the European Union – The Energy Review" Legal Annex<sup>11</sup> consultation – 24<sup>th</sup> October 2013 (closes 15<sup>th</sup> January 2014)

[Extracts from pages 10-16]

"The key EU legislation which now applies to the electricity and gas sectors is contained in the 'Third Energy Package' - this refers to a set of EU measures covering the electricity and gas sectors. It comprises the following measures:

- Regulation (EC) 714/2009: the electricity cross-border market access Regulation;
- Regulation (EC) 715/2009: the gas cross-border market access Regulation;
- Directive 2009/72/EC: the third package electricity Directive;
- Directive 2009/73/EC: the third package gas Directive; and
- Regulation (EC) 713/2009: the ACER Regulation (establishing the Agency for the Co-operation of Energy Regulators). "

"All of the measures in the Third Energy Package have the common aim of further liberalising the energy markets of the Member States, making national energy markets more transparent, both for businesses and consumers, and reducing disparities between such markets so as to make cross border access easier."

"Regulation (EC) 714/2009. This Regulation governs conditions for access to the electricity network for cross-border exchanges in electricity. In particular, the Regulation aims to set fair rules for cross-border exchanges in electricity, thus enhancing competition with the internal market in electricity while "taking into account the particular characteristics of national and regional markets". The Regulation requires the establishment of a compensation mechanism for cross-border flows of electricity, the setting of harmonised principles on cross-border transmission charges and the allocation of available capacities of interconnections between national transmission systems."

"The Regulation further aims to facilitate the emergence of a well-functioning and transparent wholesale market with a "high level of security of supply in electricity". It also provides for harmonisation of the rules on cross-border exchanges in electricity."

"Directive 2009/72/EC: **the Third Package Electricity Directive**. This establishes common rules for the generation, transmission, distribution and supply of electricity, together with consumer protection provisions, with a view to improving and integrating competitive electricity markets in the EU. The Directive also lays down rules relating to:

- (i) the organisation and functioning of the electricity sector;

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<sup>11</sup> [https://econsultation.decc.gov.uk/decc-policy/balance-of-competence-energy-review/consult\\_view](https://econsultation.decc.gov.uk/decc-policy/balance-of-competence-energy-review/consult_view)

- (ii) public service obligations;
- (iii) open access to the market, including third party access to electricity transmission and distribution networks;
- (iv) the criteria and procedures applicable to calls for tenders, the granting of authorisations and the operation of systems;
- (v) universal service obligations; and
- (vi) the rights of electricity consumers.

Further, the Third Package Electricity Directive establishes the ground rules for competition and regulation of the electricity market at national level.”

### **“Third Energy Package: Consumer Protection and Public Service Obligations**

Among the key aims of the Third Energy Package is the enhancement of consumer protection in the energy field. In this regard, article 3 of the Third Electricity Directive and article 3 of the Third Gas Directive, providing for Public Service Obligations (“PSOs”) should be noted. These obligations relate to “security of supply, regularity, quality and price of supplies and environmental protection, including energy efficiency, energy from renewable sources and climate protection”. The Directives confer a wide margin on the Member States to adopt appropriate measures to ensure that PSOs are complied with, although both Directives require national measures to be notified to the EU Commission and they are subject to complying with general principles of EU law, such as proportionality, in order that PSOs do not become a disguised means of discriminating against cross-border interests.”

### **“Third Energy Package: National Regulatory Authorities**

A further important aspect of the Third Energy Package is the obligation on the Member States to have an independent National Regulatory Authority (“NRA”) responsible for the regulation of the energy sector.<sup>30</sup> Both Third Energy Package Directives ensure the independence of NRAs, for example, by a requirement to appoint regulators for fixed minimum terms. Each Member State’s NRA is responsible for monitoring the national market to ensure that EU rules are observed. To this extent, they have a similarity with national competition authorities.

The Third Energy Package Directives contain some rules which NRAs must follow, and NRAs have various powers including to promote renewable forms of energy. In addition, NRAs are required to collaborate in some fields with NRAs from other Member States on cross-border regulatory issues.”

[end]