National Grid Electricity Transmission plc, all transmission system users, parties to the CUSC and all other interested parties

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Dear stakeholders,

Consultation on CUSC modification proposal 224

We would like further information from you on proposed changes to the Statement of the Use of System Charging Methodology[1] under CUSC[2] Modification Proposal ('CMP') 224. The methodology explains how the charges for using the electricity transmission system (known as 'Transmission Network Use of System' or 'TNUoS' charges) are calculated. These charges recover most of the costs of providing transmission infrastructure in Great Britain[3].

We are seeking further information on the questions identified in this letter by 13 August 2014.

CMP224 proposes to limit the total costs recovered from generators in Great Britain through TNUoS charges in a given year. This is to comply with European Commission Regulation (EU) No 838/2010[4] (the Regulation), which restricts average transmission charges for generators in EU member states. If implemented, CMP224 would reduce TNUoS charges for generators putting electricity onto the network and increase TNUoS charges for users taking electricity from the network (demand users).

The workgroup assessing CMP224 developed the original modification proposal and three alternatives which were submitted to us for decision. We are considering whether any of these proposals better facilitate the relevant CUSC objectives[5]. We will also consider these proposals against our principal objective and statutory duties[6].

On the information that we have at the moment, we are minded to direct the implementation of the original proposal. However, we consider that there are areas that need further consideration before we reach a decision.

Background

The total costs that transmission network owners are allowed to recover each year via TNUoS charges are set by us using the price control process[7]. The proportion of these costs recovered from generation and demand network users is determined by the 'G:D split'. This is currently

[1] The Statement of the Use of System Charging Methodology can be found in Section 14 of the CUSC.
[2] The CUSC is the Connections and Use of System Code. See National Grid's website for further details: http://www2.nationalgrid.com/uk/industry-information/electricity-codes/cusc/the-cusc/
[3] A small proportion of transmission infrastructure costs are recovered via connection charges.
[4] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:250:0005:0011:EN:PDF
[5] The relevant CUSC objectives for changes to the Use of System charging methodology are set out in standard condition C5 of National Grid's transmission licence. Our preliminary assessment against these objectives is set out in annex 1.
[6] Our principal objective is to protect the interests of current and future consumers. Further details are available here: https://www.ofgem.gov.uk/publications-and-updates/powers-and-duties-gema
[7] https://www.ofgem.gov.uk/ofgem-publications/64003/pricecontrolexplainedmarch13web.pdf

set to '27:73', ie 27 per cent of transmission network costs are recovered from generators and 73 per cent is recovered from demand network users.

TNUoS charges comprise a 'locational element' and a 'residual element'. The locational element reflects the different costs that generators impose on the network depending on where they choose to locate. The residual element is set to recover the remaining costs allocated to generation and demand through the G:D split after subtracting revenue recovered via locational charges. For generators the locational element of the charge is made up of a zonal charge that recovers the costs of the main integrated transmission system (MITS), and a local charge that recovers the costs of the assets required to connect to the MITS. For demand network users the locational element is a wider zonal charge only.

The Regulation sets ranges of allowable average transmission charges for electricity generators in the European Union. For Great Britain, the allowable range is €0-2.5/MWh. The average charge for a member state is equal to the total transmission charges collected from generators in a year divided by the total output of those generators in that year. Charges for electricity transmission losses, ancillary services and *'charges in respect of physical assets required for connection to the system'* are excluded from this calculation, so are not covered by the Regulation.

Based on current forecasts and the current G:D split of 27:73, average transmission charges for generators in Great Britain are expected to breach the €2.5/MWh upper limit at some point over the five years from 2015/16 to 2020/21. The date when this may potentially happen depends largely on the interpretation of the Regulation. This is discussed further below.

The proposals

National Grid Electricity Transmission plc ('NGET') raised CMP224 in September 2013 with the aim of adjusting the G:D split each year in order to mitigate the potential risk of exceeding the upper limit (on average generator charges) set by the Regulation. CMP224 proposes making changes to the methodology so that the proportion of revenue recovered from generation is set each year to the lower of:

- the current level, 27%; or,
- the maximum amount that results in the average transmission charge not exceeding the upper limit set by the Regulation.

The remaining allowed revenue will be recovered from demand users of the electricity transmission system.

The proposals will set the G:D split ahead of the relevant charging year based on forecasts of the relevant variables[8]. So there is a risk that charges breach the Regulation because of forecast error. To mitigate this risk the proposals include an 'error margin', ie the G:D split would be set with the aim of average transmission charges for generation being below (rather than equal to) the upper limit allowed by the Regulation. The error margin will be set each year by NGET based on historical forecast.

The workgroup assessing CMP224 developed four proposals; the original proposal and three Workgroup Alternative CUSC Modifications ('WACM') - WACM1, WACM2 and WACM3. The proposals vary based on:

- how they interpret paragraph 2(1) in Annex Part B of the Regulation which excludes *'charges in respect of physical assets required for connection to the system'* from the calculation of a member state's average electricity transmission charge; and,
- when the G:D split is set, ie the period of time between this the start of the relevant charging year.

[8] The G:D split will be set based on NGET's forecasts of demand, allowed revenue, connected generation capacity and the Pound Euro exchange rate.

Interpreting the Regulation

The workgroup considered several potential interpretations, two of which were taken forward and included in the proposals submitted to us for decision.

1. **'Strict Interpretation'** - Only connection charges are excluded from the calculation of the average charge.
2. **'Broad Interpretation'** - Connection charges and local charges for radial circuits that supply generators only ('Generation Only Spurs') are excluded from the calculation of the average charges.

Lead time for setting the G:D split

The proposals also vary based on 'lead time' between the G:D split being set and charges being introduced on 1 April each year. This will be either **two months** or **twelve months**.

A longer lead time should make it easier for network users to predict future charges but also means that the forecasts used to set the G:D split are likely to be less accurate. To mitigate this increased risk the error margin would be larger for options that use the longer twelve month lead time. Based on current data, NGET estimates that the error margin for 2015/16 would be set at seven per cent for options that use a two-month lead time and fourteen per cent for a twelve month lead time.

The four proposals submitted to us for decision comprise different combinations of the factors discussed above. They are shown in **Figure 1** below. We also have the option to reject CMP224 and maintain the current charging arrangements.

Figure 1 – the proposals

	Two month lead time (smaller error margin)	**Twelve month lead time** (larger error margin)
Strict Interpretation:	Original proposal	WACM1
Broad Interpretation:	WACM2	WACM3

CUSC Panel recommendation

The CUSC Panel (the 'Panel') voted on CMP224 at its meeting on 25 April. A majority of Panel members voted that WACM1 better meets the relevant CUSC objectives when compared to the current arrangements and the other proposals, and so should be implemented. The Panel also voted that the original proposal better meets the relevant CUSC objectives when compared to the current arrangements. The Panel members' full views appear in the Final Modification Report (the Report)[9].

Impacts and legal interpretation

All the CMP224 proposals would transfer costs from generation network users to demand network users. This would reduce the generation residual transmission charge and increase the demand residual transmission charge compared to the current arrangements. Locational transmission charges would not be affected.

[9] http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP224/

The Report contains NGET's estimates of the transfer of costs from generation to demand users under the different modification proposals over the six-year period from 2015/16 when compared to the current arrangements (see section 7 of the Report). Under options that use the strict interpretation of the Regulation, the estimated transfer of costs from generation to demand starts significantly earlier and is significantly greater than under options that use the broad interpretation. A twelve month lead time for setting the G:D split is also estimated to transfer more costs from generation to demand compared to a two month lead time. This is due to the larger error margin associated with the longer lead time.

The charging year at which costs are estimated to start to be transferred from generation to demand and the forecast cumulative transfer over the six year period starting from 2015/16 when compared to the CUSC baseline are as follows:

Proposal	Year of first transfer of costs from generation to demand	Cumulative transfer of costs 2015/16 – 2020/21 (£million)
Original	2015/16	1306
WACM1	2015/16	1582
WACM2	2020/21	20
WACM3	2019/20	107

The evidence in respect of potential consumer impact contained in the Report is limited. Our view is that there would be a negative impact for consumers in the short term but that the extent of this impact is unclear. This is because we expect that fixed energy contracts and the lack of time for network users to react to charging changes would mean that increases in demand charges would be passed on to consumers more quickly and more completely than reductions in generation charges. Longer term effects are less clear.

We welcome respondents' views on the impact on consumers of transferring costs from generation to demand under the different proposals submitted to us.

We also note that adjusting the G:D split from year to year would reduce charge predictability for suppliers and generators when compared to the current arrangements. By setting the G:D split a year in advance, options that use a twelve month lead time would mitigate this increased risk to some extent. The Report does not contain evidence that allows us to accurately compare the increased risk associated with a shorter two month lead time with the additional shift in costs from generation to demand under the larger error margin associated with a twelve month lead time. Our preliminary view is that the additional shift in costs from generation to demand associated with the larger error margins under options with a twelve month lead time is likely to outweigh benefits associated with more predictable charges.

We welcome respondents' views on the impact on consumers associated with any additional risk that suppliers and/or generators face for options with a shorter lead time for setting the G:D split as compared to options with a longer lead time.

Legal interpretation

Our preliminary view is that Paragraph 2(1) in Annex Part B of the Regulation is ambiguous and that both the strict interpretation and the broad interpretation constitute a reasonable interpretation. On balance our preliminary view is that the strict interpretation of the regulation is more persuasive. We also note that because the regulation is ambiguous in this respect, there is a real risk that future charges under an option that uses the broad interpretation of the Regulation (WACM2 or WACM3) could be successfully challenged by generators[10]. This would increase regulatory risk.

[10] This does not apply to options that use a strict interpretation of the regulation. Charges under these options will comply with the regulation regardless of which interpretation of the regulation applies.

We welcome respondents' views on the legal interpretation of Paragraph 2(1) Annex Part B of the Regulation.

Minded to position and request for information

Having considered the evidence and the Panel members' views as presented in the Report, we have decided to consult following our own preliminary assessment of the proposals against the relevant CUSC objectives and our principal objective and statutory duties in annex 1. This includes our minded-to position: **that we are inclined to direct the implementation of the original proposal**.

This is based on our preliminary view that:

- the strict interpretation is the better interpretation of the Regulation and that the broad interpretation increases regulatory risk
- we remain to be convinced that increased predictability of charges associated with a twelve month lead time outweighs the additional transfer of costs associated with a larger error margin
- therefore, that the original proposal represents the reasonable minimum transfer of costs from generation to demand to mitigate the risk of breaching the Regulation.

Our thinking is based on the evidence and information from the CUSC governance process to date. We think that there are areas where further clarification is needed for us to make a full assessment and reach a decision. With this in mind, we welcome your views on the areas discussed above. These are:

1. ***The interpretation of Paragraph 2(1) Annex Part B of the Regulation.***

2. ***The impact on consumers of transferring costs from generation to demand under the different proposals submitted to us.***

3. ***The impact on consumers of any additional risk that suppliers and/or generators face for options with a shorter lead time for setting the G:D split as compared to options with a longer lead time.***

We also welcome any other views on the impact of the proposals submitted to us and our preliminary assessment against the relevant CUSC objectives and our principal objective and statutory duties as shown in annex 1.

Next steps

Please send responses to this consultation to donald.smith@ofgem.gov.uk by 13 August 2014. All non-confidential responses will be published on our website. If you do not wish all or part of your response to be made public, you should clearly mark your response as confidential. It would be helpful if you could put any confidential information in a separate appendix so that your main response and any non-confidential information can be published.

Kersti Berge
Partner, Electricity Transmission
Signed on behalf of the Authority and authorised for that purpose

Annex 1 - Our preliminary assessment

Our preliminary assessment of the proposed changes under CMP224 against the relevant CUSC objectives and our principal objectives and statutory duties is summarised below.

We have considered the issues raised by the original and WACM proposals under CMP224 as set out in the Report. We took the responses to the Code Administrator consultation into account, and these are attached to the Report. Based on our preliminary assessment of the proposals our current view is that:

- all options proposed under CMP224 better achieve the relevant CUSC objectives compared to the CUSC baseline
- WACM1 better achieves the relevant CUSC objectives compared with the other options
- WACM1 is likely to have a greater negative impact on consumers as compared to the original proposal
- we are therefore minded to approve the original proposal
- this is in line with our principal objective to protect the interests of current and future consumers.

Assessment against the relevant objectives

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'

The options presented to us would affect competition in two ways: by bringing transmission charges for generation more closely into line with generators in other EU member states; and by affecting the predictability of transmission charges for generators and suppliers.

Bringing transmission charges for Great Britain generators more closely into line with those of their EU counterparts should reduce market distortions, resulting in more efficient trade between Great Britain and other EU member states. This should improve competition in the generation of electricity compared with the current arrangements. WACM1 would most closely align charges in Great Britain with those in other EU member states and, therefore, performs best in this respect as compared to the other proposals and the current arrangements. The original proposal performs next best in this respect followed by WACM3, WACM2 and the current arrangements.

Changing the G:D split from year to year would reduce the predictability of transmission charges for suppliers and generators compared with the current arrangements. This is likely to increase risk for both generators and suppliers and have a negative impact on competition in the supply and generation of electricity. We would expect this negative impact to be greater for options that use the strict interpretation of the Regulation (the original proposal and WACM1) as network users would have relatively little advance warning of the transfer of costs from generation to demand, which are proposed to start in April 2015. Going forward this effect should be mitigated to some extent by the longer twelve month lead time under WACM1 and WACM3.

We note that the evidence presented to us so far on the impact of reduced predictability of charges is limited. Based on the evidence available we think that the effects on trade of better aligning charges for generators in Great Britain with charges in other EU member states are more significant than the increased risk associated with changing the G:D split from year to year. Taking the above into consideration we believe that all the options presented to us better meet this objective compared to the current arrangements and that WACM1 best achieves this objective, followed by the original proposal, WACM2 and WACM3.

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)'

The proposals submitted to us would affect the residual charge for generation and demand only. Wider and local locational charges are not affected. We therefore consider that all proposals under CMP224 are neutral in respect of relevant objective (b).

Objective (c) 'that, so far as is consistent with sub-paragraphs (a) and (b), the use of system charging methodology, as far as is reasonably practicable, properly takes account of the developments in transmission licensees' transmission businesses'

We note that under current G:D split of 27:73, NGET's charges are forecast to exceed the Regulation at some stage over the period 2015/16 – 2020/21, depending on the interpretation of Paragraph2(1) Annex Part B of the Regulation. This due to increasing transmission costs relative to demand for electricity.

The original and WACM proposals under CMP224 take account of this development in NGET's and other Transmission Network Owners' and Offshore Transmission Network Owners' businesses and (to a greater or lesser degree, depending on the interpretation of the Regulation used) mitigate the risk of non-compliance with the Regulation. We therefore consider that all proposals better meet these objectives compared to the current arrangements.

As discussed above in the 'Legal Interpretation' section of the consultation letter, our view is that Paragraph 2(1) in Annex Part B of the Regulation is ambiguous and, therefore, that there is a risk of charges under options that use the broad interpretation being successfully challenged by generators. We therefore consider the options that use the strict interpretation (the original Proposal and WACM1) better meet these objectives compared to the current arrangements and the options that use the broad interpretation (WACM2 and WACM3).

Assessment against our principal objective and statutory duties

Our principal objective is to protect the interests of existing and future consumers. As discussed above, our preliminary view is that WACM1 better meets the relevant objectives compared to the other proposals and the current arrangements. However, our preliminary view is also that WACM1 will have a greater negative impact on consumers as compared to the original Proposal. This is because we remain to be persuaded that the impact on consumer bills of an additional transfer of costs from generation to demand associated with a twelve month lead is outweighed by the benefits associated with more predictable charges as compared to options that use a two month lead time. Our preliminary view is, therefore, that it is in the interests of customers to direct the implementation of the original proposal and that to do so this is in line with our statutory duties.

We also note that we are legally required to comply with the range of allowable transmission charges set out in Annex Part B in the Regulation. Our minded-to position is in line with this requirement.