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Dear Catherine,

**Project TransmiT: Further consultation on proposals to change the electricity transmission charging methodology**

Thank you for the opportunity to respond to this consultation<sup>1</sup>. We have provided a high level summary of our comments below and have included the detailed answers to the four questions posed in the consultation in the attached Annex 1. In addition we also provide some additional observations on the further submissions received since the Authority consultation of August 2013, which closed in October 2013.

**We agree with the Authority's 'minded to' position to approve WACM2.**

**It is clearly more cost reflective than the current Status Quo transmission charging methodology and better reflects the cost drivers of the SQSS.**

**It will reduce discrimination, particularly with respect to renewables, and so bring forward more renewable generation at lower cost increasing the likelihood of meeting UK Government renewables and climate change targets.**

**It will also lead to a broader energy mix and hence improved security of supply.**

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<sup>1</sup> Ofgem: "Project TransmiT Further consultation on proposals to change the electricity transmission charging methodology" 25<sup>th</sup> April 2014

**In terms of costs to consumers the modelled small increase in consumer costs is within the confidence level of the modelling so should, therefore, be considered neutral and should also not be given undue weight, particularly as, in the long term, a more cost reflective charging methodology, based on WACM2, will deliver lower costs to consumers.**

**However, we do not agree that the implementation date needs be delayed further to 1<sup>st</sup> April 2016.**

Given the Authority's position to approve WACM2; i.e. that it would be a beneficial change; it would be expected that the benefits would be brought in as soon as possible.

We are therefore concerned that the justification given to delay implementation, from 1<sup>st</sup> April 2015 to 1<sup>st</sup> April 2016, is lacking in analysis and substance, particularly given its importance and the length of time and depth of the consultation process thus far. Indeed, the lack of analysis and substantiation may leave a delay open to challenge.

Based on the limited justification provided by the Authority, we do not believe that the reasons given for delay are robust. Generators and suppliers already face uncertainty with respect to the change in the level of TNUoS tariffs they face between the Initial forecast and Final tariffs produced by National Grid. The change to WACM2 is no worse or greater than the historic change between Initial and Final tariffs. Therefore, the risks and costs faced by generators and suppliers from the introduction of WACM2 are no worse or greater than generators and suppliers currently face from the change from Initial to Final tariffs.

Significantly, there are benefits to introducing WACM2 earlier than April 2016 that have been missed out of the Authority's latest assessment. These are related to generation participating in the first CfD allocation round, and increased certainty and reduced hurdles rates from a consistent approach to implementation of change by the Authority in the industry.

The Authority's 'minded to' position to approve WACM2 has been known for some time and therefore parties have been able to take account of this position for some time. Indeed, it can be argued that the numerous recent changes to the WACM2 implementation date have themselves increased uncertainty, with the date going back from 1<sup>st</sup> April 2012 through numerous changes in the last three months to 1<sup>st</sup> April 2016. We would encourage the Authority to realise the benefits of WACM2 sooner rather than later and implement the change from 1<sup>st</sup> April 2015. The implementation date was delayed from April 2014 to April 2015 as a result of the late submission of what would now appear to be inconsequential evidence. It would be a travesty for the change process in general and in particular this thorough and exhaustive consultation process if the date of implementation was delayed further to 1<sup>st</sup> April 2016 as a result of what could be considered as simply delaying tactics.

We elaborate further on the merits of the approval of WACM2 and the implementation date below.

To help inform our response to this latest consultation we also commissioned two separate assessments of the NERA-Imperial report<sup>2</sup>. The first assessment is a review by Oxera and this is shown in Annex 2. The second is a critique by Phil Baker and this is shown in Annex 3.

### Approval of WACM2

We agree with the Authority that WACM2 best addresses the defects identified in the current GB transmission charging regime and are pleased that the Authority remain 'minded to' approve it. Fundamentally, WACM2 results in more cost reflective TNUoS charges. It recognises the different drivers of investment for peak security and for managing constraint costs, which the current Status Quo charging methodology fails to do. It also better reflects the drivers prescribed in the SQSS. In addition, this better cost reflectivity reduces discrimination, particularly with respect to renewable generation as a class, and increases effective competition, primarily in generation, which in turn will lead to lower costs for existing and future consumers. With WACM2 there is also a greater likelihood of meeting the UK Government's renewables and climate change targets than the Status Quo.

In terms of costs to customers, the consumer cost range is within the level of confidence in the modelling carried out for Ofgem by Baringa. It should also be recognised that this is a less robust modelled outcome than the power sector costs (which show an overall benefit) as it relies on the interaction with the Capacity Mechanism the details of which, as the Authority points out, have yet to be finalised by the UK Government. In this context we agree with the Authority that they should not consider the results as defective.

Furthermore, the modelled small increase in consumer costs should be considered neutral and should not be given undue weight, particularly as, in the long term, a more cost reflective charging methodology, based on WACM2, will deliver the best value for consumers.

It is also important to recognise that WACM2 would bring other benefits that have not been captured in the Baringa modelling. These would include sustainability benefits, a broader energy mix and improved security of supply.

With regard to the additional late evidence provided by RWE<sup>3</sup>, we do not consider that the case has been made by NERA/ICL that WACM2 is less reflective of LRMC of transmission reinforcement than the Status Quo. The NERA/ICL analysis is based on HVDC being the single future investment option for transmission system

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<sup>2</sup> "Assessing the Cost Reflectivity of Alternative TNUoS Methodologies" that was prepared for RWE npower (dated 21<sup>st</sup> February 2014)

<sup>3</sup> <https://www.ofgem.gov.uk/ofgem-publications/87413/nera-imperialreportassessingthecostreflectivityofalternativenuosmethodologiespreparedforrwenpower.pdf>

reinforcement. We do not agree with this position, as the type of future investment is uncertain and other transmission investment options may be more appropriate in given circumstances. In addition, NERA/ICL's own analysis shows that in almost all cases WACM2 produces tariffs that are closer to LRMC than the current Status Quo position.

Significantly, we believe that the additional late evidence provided by RWE is neither robust nor can be relied upon. This is perhaps best evidenced by the explanation given by NERA/ICL themselves in relation to what was driving lower load factor wind generation sites to be developed under WACM2 in their model. Their explanation, to Ofgem<sup>4</sup>, was "*Given the complexity of the model, it is not possible to observe precisely which of these effects is driving the result.*"

The fact that the 'unexplained' development of lower load factor power station sites in the NERA/ICL model accounts for nearly all of the purported £4.65 billion increase in power sector costs seriously undermines the credibility of their modelling.

We have provided a separate review, by Oxera, and a separate critique, by Phil Baker, of the NERA/ICL cost reflectivity analysis and these are contained in Annex 2 and 3 respectively to this response.

It is clear that Ofgem, on behalf of the Authority, and their modelling advisors Baringa have had difficulty in gaining access to the NERA/ICL model, though the reasons for this are not given. However, we would urge the Authority not to delay a decision, should access to the NERA/ICL model now be made available. As we have commented previously, the opportunity to submit the principles of and the associated details about the (NERA/ICL) model itself into the consultation process and for discussion by the CMP213 Workgroup has been available to these parties throughout the long period leading up to this point. It could be considered that it was a deliberate decision by them not to do so in order to further delay the Authority decision being made on the merits of CMP213. In our view these parties should not be given any further opportunities to deliberately delay the CMP213 decision making process.

### Implementation

As noted above, we agree with the Authority that WACM2 is more cost reflective than the Status Quo, that the Baringa modelled cost to consumers is within the confidence level of the modelling, that WACM2 will bring other benefits not captured in the modelling and therefore that WACM2 should be approved by the Authority. Given the Authority's position to approve WACM2, it would be expected that the benefits would be brought in as soon as possible. Therefore, we do not agree with the Authority's 'minded to' position that implementation of WACM2 should be delayed a further year to 1<sup>st</sup> April 2016.

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<sup>4</sup> Ofgem, 25<sup>th</sup> April 2014 para 1.52 (pg 38)

It is a concern that the reasons given for delaying the implementation of CMP213 have not been substantiated by the Authority, not in this consultation nor in the ‘update’ letters of mid December 2013 and mid March 2014. Instead, over the three months from the December letter to the March letter, the implementation date has gone back from 1<sup>st</sup> April 2014 to 1<sup>st</sup> April 2015 and now 1<sup>st</sup> April 2016, justified by a paragraph<sup>5</sup> of some 132 words, with no in-depth arguments or analysis.

Given the importance of this change to the implementation date and the length of time and depth of the consultation process thus far, it could have been considered to have merited a fuller analysis and explanation. On the limited justification provided by the Authority, we do not believe that the reasons given are robust and indeed that they could be open to challenge. The reasons given in the consultation document are threefold:

1. generators would not be able to adjust their capacity [TEC] in response to early implementation without incurring penalties;
2. hurdle rates for future investment may increase, as early implementation may increase policy uncertainty;
3. suppliers may increase the risk premia built into their fixed tariffs if they do not have sufficient time to plan for changes in transmission charges.

We disagree with these reasons as justifying the change in the proposed implementation date to 1<sup>st</sup> April 2016 with our views given on each in turn below.

#### *Impact on generators*

Generators are always faced with uncertainty when making their decisions on how much transmission capacity (TEC) they should book. Currently, with a notice period of one year and five working days to avoid penalties, generators make these decisions based on National Grid’s Initial forecast of TNUoS tariffs. These Initial forecast are subject to change. However, by the time the TNUoS tariffs are made Final by National Grid, at the end of January, the generator is already locked in to their transmission capacity for the charging year in question (unless they wish to incur the cancellation penalty). We have assessed the variation between Initial and Final TNUoS tariffs and have provided this in our response to Question 4, which is contained in Annex 1. It is clear from this analysis that the change from Status Quo to WACM2 is within the range of historical tariff changes seen by generators since 2009/10. This has also been analysed and confirmed by National Grid<sup>6</sup>. On this basis, the change to WACM2 is no worse or better than the normal ‘business as usual’ change between Initial and Final TNUoS tariffs that generators see every year. Given this, it would be reasonably expected that generators do include a risk premium in their economics to cope with the change from Initial to Final (including to cover the view that the change in TNUoS tariffs could cause them to close) and, therefore, as the change to WACM2 is within the range of historical Initial to Final TNUoS tariff

<sup>5</sup> Ofgem, 25<sup>th</sup> April 2014 para 2.54

<sup>6</sup> Ofgem, 1<sup>st</sup> August 2013 para 6.101

changes, then so should any risk associated with WACM2 be within the risk that is normally managed by generators. On this basis, we do not believe that the change to WACM2 poses any greater risk to generators than they already cope with and therefore that the justification given by the Authority is unsound.

#### *Impact on Hurdle Rates*

There are two points to be made on hurdle rates. The first is that the Authority's 'minded to' position has been known since the publication of its August 2013 Impact Assessment consultation. This 'minded to' position has, subsequently, been repeated on at least three separate occasions (in mid December 2013, mid March 2014 and, finally, with this latest April 2014 consultation). Indeed, the Authority's *policy intent* has been known since June 2012 when National Grid were directed by the Authority to raise a CUSC Modification Proposal (CMP213). Therefore, the change to the GB transmission charging arrangements will have been factored into both generators' and suppliers' plans for some time, and the possibility of the Authority approval of WACM2 should not therefore be considered a surprise to them.

Indeed, it can be argued that it is the numerous recent changes by the Authority to the proposed implementation date that undermines certainty and increases hurdle rates. As late as summer 2011, the original implementation date was anticipated to be 1<sup>st</sup> April 2012. The 'minded to' implementation date, for WACM2, then moved slowly back to 1<sup>st</sup> April 2014 until the Authority's mid December 2013 position, from when it has rapidly moved back from 1<sup>st</sup> April 2014 to 1<sup>st</sup> April 2015 then to 1<sup>st</sup> April 2016 in the space of three months.

Secondly, reflecting the fact that there is always uncertainty associated with the change from the Initial to Final TNUoS tariffs, if such uncertainty is significant enough to be captured in a generator's hurdle rates for investment, then since the change to WACM2 is within the range of historical Initial to Final TNUoS tariff changes, then any impact of WACM2 on hurdle rates would also be within historic hurdle rates associated with TNUoS tariffs.

#### *Impact on Suppliers*

It has been put forward that suppliers may be affected by both the change in the wholesale price as a result of the impact of WACM2 on generators and the impact of the change in Demand TNUoS tariffs. There are a number of points that can be made on each of these.

Firstly, the change in the wholesale price (if there is one) associated with the change in generator TNUoS arising from WACM2 is going to be very small compared to the expected volatility in the actual wholesale price caused by, for example, commodity price volatility, renewable generation output and interconnector flows. Suppliers currently cope with and have their own strategies for managing wholesale price risk.

Secondly, as noted above the change in TNUoS tariff associated with WACM2 that may be considered to be driving the wholesale price changes is well within the historic change in Initial to Final TNUoS tariffs experienced by generators over many years, so is well within the normal historic change in the wholesale price resulting from a change in generator TNUoS tariffs.

Thirdly, again as noted above, the change to WACM2 has been trailed for some considerable time and it would therefore be reasonably expected that suppliers; exercising good industry practice; would have taken account of this already in the normal course of their business.

If a supplier has demonstrably failed to exercise ‘good industry practice’, by not taking into account the repeatedly<sup>7</sup> stated Authority ‘minded to’ position to implement CMP213 it would be perverse if the Authority protected those suppliers from their failures. This is important in the context of those suppliers who have exercised ‘good industry practice’ and could be seen to be them being punished in this instance for doing so.

In relation to the change in Demand TNUoS tariffs, which are expected to be very minor (if at all), again the proposed changes arising from WACM2 can be shown to be no greater than historic Initial to Final TNUoS tariff changes that suppliers have historically experienced. Secondly, as suppliers operate within GSP Groups, all suppliers in a GSP Group are similarly affected so that there is no competitive advantage or disadvantage arising from the proposed change to WACM2. Thirdly, suppliers cope with much greater changes to their cost base on an ongoing basis through; e.g. changes to DUoS Charges, BSUoS and the volatility of the wholesale price.

Fourthly, not all supplier contracts are fixed term contracts<sup>8</sup> and delaying a change to WACM2 could be seen to discriminate against those suppliers who provide other forms of contracts to their customers.

Similar arguments about not being able to cope with a change in TNUoS tariffs were put forward by parties to prevent the implementation of the GB ECM-21 mid-year tariff change<sup>9</sup> for the OFTOs in the autumn of 2010. These arguments were explicitly rebutted by National Grid<sup>10</sup> and implicitly by the Authority in approving that change. In our view nothing has changed since that time, when those arguments were persuasive enough for the Authority to approve the mid-year tariff change.

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<sup>7</sup> August 2013, December 2013, March 2014 and April 2014

<sup>8</sup> Whilst often stated, little evidence has been forthcoming from suppliers to substantiate this claim in terms of the volume (be that overall customer numbers or % of energy purchased) that they have on fixed term contracts by duration beyond, say, 1<sup>st</sup> April 2015

<sup>9</sup> GB ECM-21 <http://www.nationalgrid.com/NR/rdonlyres/0129372D-E96D-4B0B-9E0F-A564705995DD/40216/GBECM21ConclusionsreportFinal.pdf>

<sup>10</sup> See, for example, the National Grid GB ECM-21 report to the Authority, sections 4.2, 4.3 and 4.4

It could be considered that delaying the implementation of WACM2 to account for (i) the notification period for generators' TEC changes and (ii) suppliers fixed term contracts with consumers seems to be micro-managing the market by the Authority and thus removing the need for any risk management function on the part of generators and suppliers. It also unduly penalises those generators and suppliers who have applied 'good industry practice' and considered the risks involved and taken appropriate steps accordingly to mitigate those risks. Given that generators and suppliers will have different hedging strategies, the decision to delay WACM2 implementation will inevitably favour some parties (who have sat back and done nothing) more than others (who have taken prudent steps to hedge / mitigate the effects).

The Authority's stance in relation to this CMP213 Modification seems to contradict the position taken on a number of other changes approved by the Authority or where the Authority has set out its clear policy intent. There are a number of examples of these that we have included in our answers to the questions posed in this consultation (see Annex 1), the most recent of which is the Authority's policy decision, a couple of weeks ago, to introduce a more marginal cash-out price under the Electricity Balancing SCR. Given that this is a significant change with the stated intention, by the Authority, that it will have a material change to the cash-out arrangements, and given that the first stage is intended to be implemented by this coming November<sup>11</sup>, with its associated impact on both generators and suppliers, it can readily be seen to contradict the proposed implementation position being taken by the Authority on WACM2.

There are several benefits to an earlier, than 1<sup>st</sup> April 2016, implementation date for WACM2, as described below:

- **CfD power stations will be able to respond without penalty, so an earlier implementation could reduce customer costs** - CfD power stations participating in the first CfD competitive allocation round in Autumn 2014 to receive CfD contracts commencing 1<sup>st</sup> April 2015 would also have the opportunity to react to the earlier implementation, of CMP213, on 1<sup>st</sup> April 2015 by changing their strike price. These CfD contracted power stations would be able to reduce their bid prices in the CfD allocation round, which could result in a lower clearing price and a sustained lower cost to customers. This benefit was recognised by Baringa<sup>12</sup> in their modelling of costs to customers and if the implementation date for CMP213 is delayed to 1<sup>st</sup> April 2016, then this first year of benefit to customers from reduced low carbon support costs would be lost.
- **Repeated delays and a failure to implement by 1<sup>st</sup> April 2015 could increase future hurdle rates** - Continued commitment by the Authority to

<sup>11</sup> Ofgem: Electricity Balancing Significant Code Review - Final Policy Decision, 15<sup>th</sup> May 2014 footnote 16 "Reference to 'by early winter' indicates our intention for changes to be reflected in Elexon's last release before winter, usually in November"

<sup>12</sup> Baringa, 25<sup>th</sup> April 2014 page 64



their intention to implement quickly, which until mid December 2013 was a “minded to” implement on 1<sup>st</sup> April 2014 (that had been extensively consulted on and well signalled to the market), could help ensure the policy environment remains predictable from the investors’ perspective which could in turn help to lower investment hurdle rates for new generation. By contrast, the change outlined in mid December 2013 to the subsequent ‘minded to’ position to implementation on 1st April 2015, then the further change, by the Authority, to being “minded to” delay implementation to 1<sup>st</sup> April 2016, increases the perception of risk around the transmission charging regime, and hence may increase future hurdle rates. It could be a significant concern that any future proposals for market change may be delayed and drawn out far beyond the timescale initially intimated as was already the case with CMP213 at August 2013. This would be perceived as a step change increase in policy risk, and would lead to an increase in the required hurdle rates for generation investment and ultimately to higher costs to consumers.

- **Similarly such delay to a well heralded policy change could be perceived as an increase in policy risk by suppliers, leading to an increase in future risk premiums in Supply tariffs, ultimately leading to increases in customer bills** – As above regarding generator hurdle rates, an early implementation of CMP213 would be perceived as in line with industry expectations regarding the expected impacts of policy risk. However, a delay to the implementation of CMP213 could be seen to undermine the consultation and implementation cycle for future policy changes which could result in an increase to future supply tariff risk premiums.

A further reason is provided by the Authority in Appendix 2, section 1.53

*"We would expect a charging option that reduces TNUoS for onshore wind to lead to the cheapest projects to be developed, particularly under the current CfD arrangements."<sup>13</sup>*

Given that the CfD arrangements will enter into force as early as 2014 we consider that Ofgem should by their own reasoning seek to implement as early as possible in order to help see the cheapest projects being developed.

Oxera has provided support to the notion that it is better to implement early:

*"In addition, Ofgem does not appear to consider factors suggesting that delayed implementation may also have undesirable implications; namely, by increasing risk perception through a break with a previously signalled position on the timing of implementation. It is possible that, on balance, the overall impact of delayed implementation is negative."<sup>14</sup>*

and

<sup>13</sup> Ofgem, 25<sup>th</sup> April 2014 para 1.53 (pg 39)

<sup>14</sup> Oxera 27<sup>th</sup> May 2014, page 2

*“Specifically with regard to the date of implementation, in its August 2013 consultation Ofgem had indicated that it is minded to approve implementation in April 2014. A significant delay to this signalled position could increase the perception of risk around the transmission charging regime.”*

We recognise that as with previous Authority decisions on the CUSC (and other industry code changes) this one will be made not just on the Applicable CUSC Objectives but also on the wider aspects of the benefits/disbenefits associated with the change in line with the Authority’s wider statutory duties, and therefore it would be possible to justify each of the changes previously approved as being suitable to the circumstances at the time.

However, recognising that, it is clear that fundamentally WACM2 is better than the existing Status Quo GB transmission charging methodology, as the Authority is ‘minded to’ approve it. With that as a given, we have strongly argued that the justification for a delay in implementation to 1<sup>st</sup> April 2016 put forward by the Authority in the latest consultation document is not robust and that there are benefits to introducing the WACM2 changes earlier (than 1<sup>st</sup> April 2016) that have been missed out of the Authority’s assessment. On this basis we believe it is appropriate to implement WACM2 on 1<sup>st</sup> April 2015. The implementation date was delayed from April 2014 to April 2015 as a result of the late submission of what would now appear to be inconsequential evidence. It would be a travesty for the change process in general and in particular this thorough and exhaustive consultation process if the date of implementation was delayed further to 1<sup>st</sup> April 2016 as a result of what could be considered as simply delaying tactics.

Yours sincerely

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Enc: Annex 1, Annex 2 and Annex 3.