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Dear Donald,

Consultation on CUSC Modification Proposal 224

Thank you for the opportunity to respond to this consultation¹.

In the letter (and annex) of 14th July 2014 from your colleague Kersti Berge, there was a specific request for additional views on three specific points, namely:-

- 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 address each of these questions in turn and also provide comments with respect to the Applicable Objectives and Wider Statutory Duties.

Questions

¹ <https://www.ofgem.gov.uk/publications-and-updates/consultation-connection-and-use-system-code-modification-proposal-224>

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

We note the observation set out in the 14th July letter that “*both the strict interpretation and the broad interpretation constitute a reasonable interpretation*” of Paragraph 2(1) in Annex Part B of the Regulation.

The letter goes on to state that “*On balance our preliminary view is that the strict interpretation of the regulation is more persuasive*”.

We entirely agree with this preliminary view.

As we have detailed, at length, in our response to both the CMP224 Workgroup consultation and, more recently, the CMP224 Code Administrator consultation there are very strong legal arguments supporting this ‘*strict*’² interpretation of the requirements of Paragraph 2(1).

For the reasons we have detailed in our two previous CUSC CMP224 consultation responses there is not, in our view, any ambiguity in Paragraph 2(1) in Annex Part B of the Regulation and, therefore, the ‘*broad*’ interpretation is both legally erroneous and wholly without merit.

In coming to this view we have been mindful of (a) National Grid’s summary legal opinion presented to the CMP224 Workgroup and (b) our detailed examination of the legal matters that arise from CMP224.

We believe there are clear legal reasons to take a ‘*strict*’ interpretation to **include** (rather than a ‘*broad*’ interpretation to **exclude**) all assets subject to local TNUoS charges within the calculation of the annual average transmission charges when calculating the GB position with respect to the €2.5 limit.

We have detailed, at length, our legal reasoning in our two previous responses to the CUSC CMP224 consultation and provide an extract of these in Annex 1 to this letter.

For these reasons we strongly believe that the legal interpretation of Paragraph 2(1) in Annex Part B of the Regulation is clear and that it is appropriate; based on a ‘*strict*’ interpretation; for CMP 224 Original to be implemented such that all charges paid by producers for connection to the “local” network are **included** in the calculation of the “annual average transmission charges” for the purposes of Part B of the Regulation.

Given the comments above, and our previous detailed comments, we therefore strongly disagree with the contention in the 14th July letter that there is any ambiguity around the ‘*strict*’ interpretation Paragraph 2(1) in Annex Part B of the Regulation. In our view the legal position is not ambiguous.

² We do not characterise the issue as one of ‘strict’ and ‘broad’ legal interpretation as the letter of 14th July does. In our view the correct legal interpretation is to **include**, and the incorrect legal interpretation is to **exclude**, the items from the calculation.

Notwithstanding that, we believe that there is a very high degree of ambiguity around the ‘*broad*’ interpretation of the legal matters at hand and we agree that “*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*” in a court of law.

We also agree with the contention in the 14th July letter that “*This would increase regulatory risk*”.

In light of the above we strongly believe that the ‘*strict*’ interpretation is the legally correct and thus the better interpretation of the Regulation and that the ‘*broad*’ interpretation is the legally incorrect and thus worse interpretation of the Regulation which, if implemented, would also increase regulatory risk.

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

As we have set out previously, when considering the impact that CMP224 would have on end-consumer bills, we believe that the effect would be neutral.

This is because we would expect that the differences between the generation revenue and the demand revenue to be fully reflected in the wholesale price; i.e. if the revenue to be recovered from generation reduced by £1 (due to TNUoS charges coming down by £1) this would manifest itself in a corresponding reduction of £1 in the wholesale price of electricity paid for by demand.

If this were not to happen, then generators would see their profits increase, in this simple example, by £1.

However, we agree with the Authority, in their recent Project Transmit decision of 25th July³ that:-

“In a competitive market, we would expect these profits to be eroded through competition and that benefit transferred to consumers.”

We also agree with the Authority, in that same Project Transmit decision of 25th July, that “*we [The Authority] consider that ...the generation market is competitive*”⁴.

Given this we therefore conclude that whilst there will be a monetary transfer of costs, from generation to demand, and that this transfer may well be of the order set out in

³ <https://www.ofgem.gov.uk/ofgem-publications/88994/projecttransmitdecisiononproposalstochangeelectricitytransmissionchargingmethodology.pdf>

⁴ Para 2.52 “Finally, we consider that as the generation market is competitive, it is reasonable to assume that in the long run that generators will respond in a way that erodes the level of additional profits under WACM 2 currently shown in the modelling.”

the table on page 4 of the 14th July letter that this will be offset by an equal and opposite monetary reduction in the wholesale price of electricity as the competitive generation market responds to this change in TNUoS (from generation to demand). Therefore we would expect the impact that implementing CMP224 Original would have on end-consumer bills to be neutral.

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

There is a risk faced by both suppliers and generators with all the four options (CMP224 Original, WACM1, WACM2 and WACM3).

This is because, as footnote 8 of the 14th July letter summarises, “*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*”.

The CMP224 Workgroup considered each of these variables in detail and developed a robust solution to addressing these variables.

The robust solution was to include a margin for error to take account of these variables. Modelling was undertaken looking at previous variances of these variable elements - demand, allowed revenue, connected generation and the £/€ exchange rate. The CMP224 Workgroup examined the modelling results and concluded that an ‘error margin’ of 7% for a two month notice period (and then 12 month application) was appropriate whilst a 14% ‘error margin’ was also appropriate for a 12 month notice period (and then 12 month application).

It seems to us, given either the public availability of information / forecasts or the ability for a party exercising good industry practice to undertake forecasting of the four variable elements (demand, allowed revenue, connected generation and the £/€ exchange rate) themselves⁵, that parties should be able to come to a view on these variables such “*that the additional shift in costs from generation to demand associated with the larger error margins under options with a twelve month lead time*” can, to some extent, be mitigated such that it is less than the 7% ‘premium’ associated with moving from two months (7%) to 12 months (14%).

Applicable Objectives and Wider Statutory Duties

We have considered the preliminary assessment of the CMP224 in terms of the Applicable CUSC Objectives and the Authority’s wider statutory duties as set out in Annex 1 to the 14th July letter.

⁵ Or commission consultants to do it for them.

In terms of the Applicable CUSC Objectives the relevant objective is (a). We agree that CMP224 is neutral with respect to (b) and that the arguments, in respect of (c), are appropriate.

We agree with the statement, in the 14th July letter, that:-

“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.”

As we have set out in detail in our previous CUSC CMP224 consultation responses, there are clear arguments to support this position. We provide an extract of some of these relevant comments in Annex 2 to this consultation response.

Given the above, we therefore agree with the statement, in the 14th July letter, that:-

“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.”

In terms of the Authority’s wider statutory duties we agree that the Authority (along with the UK Government) *“...are legally required to comply with the range of allowable transmission charges set out in Annex Part B in the Regulation”*.

We agree that the Authority’s *“...minded-to position is in line with this [legal] requirement”*.

Conclusions

We note the Authority reasoning set out in the 14th July letter as to the basis of their ‘minded to’ position to approve CMP224 Original.

We agree that a ‘strict’ interpretation is the better and, in our view, is the legally correct interpretation of the Regulation and that the broad interpretation is, in our view, legally incorrect and increases regulatory risk

Having examined the position set out by Authority, and considered the CMP224 Final Modification Report, we agree that the increased predictability of charges associated with a twelve month lead time appears to outweigh the additional transfer of costs associated with a larger error margin of 14% (compared to 7% with the two month lead time).



We therefore agree with the 'minded to' position that the CMP224 Original proposal represents the reasonable minimum transfer of costs from generation to demand to mitigate the risk of breaching the Regulation.

Yours sincerely

Garth Graham
Electricity Market Development Manager

Enc: Annex 1 and Annex 2.

**Annex 1 – Extract from SSE response to CMP224 Code Administrator
Consultation response 28th March 2014.**

“In our view the correct legal interpretation of EU Regulation 838/2010 Part B, and in particular paragraphs 1, 2 (1) and 3 thereof, is that all local generation TNUoS charges should be **included** within the annual average transmission charges as part of defining a cap on the proportion of TNUoS charges paid by generation in GB under the proposed solution.

In our view it would be wholly sensible based on (a) National Grid’s summary legal opinion and (b) our view of the legal matters that arise from CMP224 to **include all** assets subject to local TNUoS charges within the calculation of the annual average transmission charges when calculating the GB position with respect to €2.5 limit.

In our view this would be consistent with the terms of EU Regulation 838/2010 Part B, and in particular paragraphs 1, 2 (1) and 3 thereof.

The Regulation imposes a limit on the annual average transmission charges which are paid by producers (generators) in each Member State. The issue that the CMP224 Workgroup considered related to the interpretation of what constitutes “transmission charges” within the Regulation and the exclusions there from.

We consider that the CUSC is the most relevant document to consult when seeking to determine, in the context of GB, the practical application of Regulation 838/2010 Part B as it deals, explicitly, with the connection to and charges arising from the connection to and use of the transmission system in GB.

In order to assist the Workgroup to consider this matter, National Grid provided (at the first Workgroup meeting) an illustrative example of the GB electricity transmission system. The relevant slide is number 12 (‘Local Charges’).

It was common ground amongst the Workgroup members that (i) the red 'Local' network and the black 'Wider' network (shown on slide 12) are, collectively, known as the National Electricity Transmission System (or 'NETS') and that the 'Wider' network, as illustrated on the slide, is the Main Integrated Transmission System (or 'MITS') and that (ii) the green Generator specific assets are neither part of the NETS or MITS.

Part B of the Regulation includes the following pertinent passages:-

“Annual average transmission charges paid by producers is annual total transmission tariff charges paid by producers divided by the total measured energy injected annually by producers to the transmission system of a Member State.” [Statement 1]

“For the calculation set out at Point 3[Statement 3], transmission charges shall exclude:

charges paid by producers for physical assets required for connection to the system or the upgrade of the connection” [Statement 2]

“The value of the annual average transmission charges paid by producers shall be within a range of 0 to 0,5 EUR/MWh, except those applying in Great Britain.... Annual average transmission charges paid by producers in ... Great Britain... shall be within a range of 0 to 0,25 EUR/MWh...” [Statement 3]

[emphasis added]

It was common ground amongst the Workgroup members that it is necessary for GB to ensure that the average transmission charges paid by generators in GB remain within a range of €0-€2.5 (as per paragraph 3 [Statement 3] of Part B of the Regulation) or such other figure as maybe amended from time to time by the European Commission.

The question which arose within the Workgroup was what item(s) does or does not make up the definition of “transmission charges” and in particular which aspects, if any, of those charges should be treated as **excluded** as ‘charges’ for ‘connection’ to ‘the system’, as set out in Statement 2.

We believe there are clear reasons to **include** (rather than **exclude**) all assets subject to local TNUoS charges within the calculation of the annual average transmission charges when calculating the GB position with respect to the €2.5 limit.

These reasons include:-

(a) It is our contention that it is possible to determine (in the context of GB) what is (i) meant by ‘connection’, including by reference to the CUSC definition⁶ of it and (ii) the ‘system’, by noting that Statement 2 is written to ensure the calculation set out in Statement 1 is undertaken in order to determine the range set out in Statement 3 is not exceeded. Those who drafted the Regulation must have given specific consideration to what was included in the definition of “transmission charges” within each Member State and the GB system in particular, in order to arrive at the different caps provided for each Member State.

(b) It is our contention that it cannot sensibly be concluded that Statement 2 of the Regulation has no meaning within the GB system since the Regulation would, in effect, be rendered unenforceable. On the contrary, read in the context of both Statement 1 and Statement 3, the only reasonable conclusion is that the ‘system’ referred to in Statement 2 is one and the same as the ‘transmission system’ in

⁶ This is shown in Appendix 1 to this response.

Statement 1.

(c) It is our contention that as the CUSC currently defines⁷ (i) what is meant by ‘Connection Charges’ and (ii) that National Grid produces invoices and issues these to generators for the said ‘Connection Charges’ (in accordance with CUSC Section 2.14.1⁸) that it is possible today to complete the calculation required in Statement 2 by reference to said ‘Connection Charges’ paid by GB generators to connect to said ‘system’ in GB.

(d) It is our contention that the section of the CUSC⁹ which deals with “Connections” (Section 2) refers only to NETS¹⁰ and does so on no less than 26 occasions, whilst there is (in Section 2) no reference to MITS. Therefore, it is contended that the only sensible interpretation is to view ‘connection’, in a GB context, in terms of the ‘system’ being the NETS (and not the MITS).

(e) Furthermore, it is our contention that the matter of where a generator connects to the ‘system’ should be clear to National Grid as, for example, it was recently the subject of an opinion by the Authority in its decision letter of CAP189¹¹ where it was noted that:-

“A generator or a distribution network is generally connected to the transmission network through a substation to provide both protection and control to the transmission network. The substation assets form an electrical boundary. The CUSC (section 2.12) defines the standard boundary and sets out how ownership of the assets at the boundary is split between the connecting user and the National Electricity Transmission System (NETS) for different types of asset.”

The Authority’s decision letter goes on to note that CAP189 was raised by National Grid itself (in July 2010) and that “[t]he proposal seeks to amend the CUSC so that a user requesting a connection to the NETS through a GIS substation can elect to do so using either of two standard ownership boundaries”.

(f) It is our contention that National Grid has already set a precedent in how to undertake the calculation in Statement 2 when it undertook that same calculation to inform the Authority’s Project Transmit Technical Working Group as witnessed by its presentation¹² to that group in August 2011 and in particular slides 5, 6, 7, 9, 10 and

⁷ This is shown in Appendix 1 to the SSE CMP224 Code Administrator Consultation response.

⁸ This is shown in Appendix 1 to the SSE CMP224 Code Administrator Consultation response.

⁹ This is shown in Appendix 1 to the SSE CMP224 Code Administrator Consultation response.

¹⁰ 2.1.1 x1, 2.1.2 x2, 2.2.1 x1, 2.2.2 (b) x1, 2.2.3 x1, 2.2.4 x2, 2.3.1 x2, 2.3.2 x2, 2.4 x1, 2.5 x1, 2.7 x1, 2.12.1 (a) x1, 2.12.1 (b) x2, 2.12.1 (c) x1, 2.12.1 (d) x1, 2.12.2 x1, 2.13.7 x1, 2.13.11 (a) x2, 2.13.11 (b) (i) x1 and 2.13.12 x1.

¹¹ <http://www.nationalgrid.com/NR/rdonlyres/7BE14FC7-7AE6-409F-82F6-1A8A117D0B8B/51173/CAP189D.pdf>

¹² https://www.ofgem.gov.uk/sites/default/files/docs/2011/08/transmit-wg-postmtg4_eu-tarification-guidelines.pdf

11 which were calculated, by National Grid, “in accordance with the *European Tarification Guidelines*”¹³ .

For these reasons we strongly believe that the legal position is clear that it is appropriate for CMP 224 to be adopted such that all charges paid by producers for connection to the “local” network are **included** in the calculation of the “annual average transmission charges” for the purposes of Part B of the Regulation.”

¹³ page 9 of the group’s minutes 18th August 2011
<https://www.ofgem.gov.uk/sites/default/files/docs/2011/09/minutes---working-group-meeting-4-%28version-1.0%29.pdf>

Annex 2 – Extract from SSE response to CMP224 Code Administrator Consultation response 28th March 2014.

“We are aware of a recent detailed independent study¹⁴ undertaken into generator transmission charges across four countries in Europe¹⁵ on the matter of harmonisation. The conclusions of that report are shown below and these clearly show that harmonisation of generator transmission charges is the economically correct thing to do.

A lack of harmonisation or changes to generator transmission 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.

First, they can result in distorted operational decisions. If a low cost generator in country A faces high transmission charges, it may not produce electricity, with demand instead being satisfied by a higher cost generator in country B where transmission 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 transmission 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 transmission 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).

We endorse these conclusions. It is clear to us that the higher range of average annual transmission tariffs paid for by generators in GB (plus Northern Ireland and Ireland) are having a distorting effect on the GB¹⁶ generation market.”

¹⁴ The study has been provided to us in confidence. We have provided the reference etc., to the Authority under separate cover in response to their recent consultation on “Impact assessment on CMP201 - proposal to remove balancing charges from generators”.

¹⁵ France, Germany, Belgium and the Netherlands.

¹⁶ plus Northern Ireland and Ireland