

Modification proposal:	Connection and Use of System Code (CUSC) CMP267: Defer the recovery of BSUoS costs, after they have exceeded £30m, arising from any Income Adjusting Events raised in a given year, over the subsequent two charging years.		
Decision:	The Authority ¹ has decided to reject ² this modification		
Target audience:	National Grid Electricity Transmission PLC (NGET), Parties to the CUSC, the CUSC Panel and other interested parties		
Date of publication:	07 December 2016	Implementation date:	n/a

Background

The costs of balancing the electricity transmission systems are recovered by National Grid equally from generators (50%) and suppliers (50%) through Balancing Services Use of System (BSUoS) charges based on their use of the system. These charges are calculated - based on the cost of the actions National Grid needs to take to balance the system - for each 30 minute settlement period. National Grid provides ongoing forecasts of the likely level of BSUoS charges (£/MWh). Actual costs are calculated and charged to suppliers and generators *ex post*.

Because the exact BSUoS charge per MWh is not known in advance, market participants apply a 'risk premium' to their contracts to protect themselves against the potential for higher than expected BSUoS costs. Volatile and unpredictable BSUoS charges are just one of the risks that market participants are seeking to manage in their risk premiums.

National Grid is incentivised to incur balancing costs as efficiently as possible through the Balancing Services Incentive Scheme (BSIS). The BSIS forecasts an annual target for total BSUoS charges. National Grid can make a profit, if it manages to balance the system for less than the target. If it spends more than the target, National Grid loses money. This profit or loss is capped at +/- £30m.

If an event occurs which National Grid could not have foreseen or controlled and which increases or decreases National Grid's position against the BSIS target by a material amount, National Grid may apply for an income adjusting event (IAE). If approved by us, the specific costs related to the IAE are removed from the calculation of National Grid's incentive payments. The costs associated with an IAE are recovered by National Grid as normal through BSUoS, regardless of our decision to adjust National Grid's incentive. Because of their unpredictable nature, the IAE costs contribute to the volatility of BSUoS charges that market participants seek to protect themselves against with risk premiums.

CMP267 was raised by EDF Energy on 18 July 2016 in the context of a request by National Grid for us to approve two IAEs with a combined total value of £113 million. On 1 August, we approved a request for CMP267 to be treated as urgent on the basis that it seeks to address an imminent issue that could have a significant commercial impact on market participants.

CMP267 proposes changes to Section 14 (Charging Methodologies) of the Connection and Use of System Code (CUSC) to defer recovery of costs associated with an IAE and thereby aims to mitigate the impacts on market participants of short-notice, material and unforeseen increases in BSUoS charges associated with IAEs.

¹ References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

² This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

The modification proposal

The change proposal asserts that short-notice, unforecastable changes to BSUoS, such as those associated with an IAE, create risks that are hard for any market participant to finance efficiently, adding to consumer costs; the proposer considers they may also have more adverse impacts on some categories of participant than others.

CMP267 seeks to address this by deferring recovery of costs associated with an IAE over the next two charging years. According to the proposer, this would give market participants more advanced notice of increases to BSUoS charges, as well as lower the magnitude of the impact by smearing recovery of the costs over a longer period.

Only IAE costs in excess of £30 million within a charging year (either from a single event or a number of smaller events) would be deferred. Any IAE costs up to £30 million would be recovered as normal.³ Deferred costs would be recovered from market participants in the subsequent years on the basis of their traded volumes in those years, as opposed to the year in which the IAE costs were incurred.

Because an IAE occurring late in the charging year could, under the original proposal, still result in price shock (with the £30m below the threshold for deferral being collected in a relatively short period of time), a Workgroup member raised a Workgroup Alternative CUSC Modification (WACM). The aim is to ensure that the amount of IAE costs recovered in a month cannot exceed £2.5m. Under the WACM, instead of a threshold of £30m, recovery of IAE related costs would be capped at £2.5m per calendar month for the remainder of the first charging year and all of the second charging year. Any remaining costs from the IAE would be collected over the third charging year.

Under both the original and the WACM, National Grid's request for an IAE would be the 'trigger' for deferral of recovery of any costs over the threshold. This is justified on the basis that an IAE request can be seen as a signal that the costs could not have been foreseen by the market. Any costs already recovered prior to National Grid's request to us for an IAE would not be affected by CMP267.

The FMR explains that CMP267 would require changes to National Grid's licence to allow costs incurred in one charging year to be recovered in another. The proposed implementation date for CMP267 is 1 day after an Authority decision to implement required licence changes.⁴

CUSC Panel⁵ recommendation

At the CUSC Panel meeting on 15 November 2016, a majority of the CUSC Panel considered that the CMP267 original proposal would better facilitate the CUSC objectives and the Panel therefore recommended its approval.

Seven Panel members voted in favour of the original proposal as the best option. These panel members considered that the proposal would better facilitate competition in the generation and supply of electricity while remaining neutral against the other relevant CUSC objectives. The members noted in particular the potential for CMP267 to reduce BSUoS uncertainty arising from IAEs. While no Panel members voted for the WACM as the best option, six members consider the WACM better than the Baseline. The additional

³ Section 14 of the CUSC describes the methodology for calculating BSUoS charges.

⁴ The process for making changes to the licence requires a minimum 28 day consultation period and a 56 day 'standstill' period before the changes take effect.

⁵ The CUSC Panel is established and constituted from time to time pursuant to and in accordance with section 8 of the CUSC.

complexity of the WACM, relative to the original proposal, was noted by the panel members.

Two members voted in favour of the Baseline. They did not agree that competition would be better facilitated and one did not consider the proposals to be compatible with the efficient implementation of the system charging methodology because of the additional process required by the proposals.

Our Decision

We have considered the issues raised by the modification proposal and the Final Modification Report (FMR)⁶ dated 23 November 2016. We have considered and taken into account the responses to the industry consultation on the modification proposal which are attached to the FMR.

We have concluded that implementation of the modification proposal will not better facilitate the achievement of the applicable objectives of the CUSC⁷ and would not be in keeping with our principle objective of exercising our functions in a way that protects the interests of existing and future consumers.

Reasons for our decision

We have set out below our assessment of the impacts of the proposal on relevant CUSC charging objectives (a) and (b). We consider it has a neutral impact on the other relevant CUSC charging objectives.

(a) Compliance with the use of system charging methodology facilitates effective competition in the generation and supply of electricity and (so far as consistent therewith) facilitates competition in the sale, distribution and purchase of electricity

The proposer and a majority of Workgroup and CUSC Panel members considered that deferring IAE cost would better facilitate competition by removing uncertainty for all.

Qualitative evidence

The Workgroup was not able to quantify these benefits, noting that the unpredictable nature of IAEs means that it is difficult to build in specific risk premiums. In previous modification discussions⁸, the possibility of a data gathering exercise by Ofgem on risk premiums was considered. In those discussions, it was acknowledged that this would be unlikely to provide useful information because different parties view risk differently and contract in diverse ways. Instead the FMR presents qualitative arguments in support of CMP267.

Impact of IAEs on supplier competition

The FMR argues that suppliers with more customers on non-passthrough (fixed price) contracts could be more adversely affected because they are unable to pass through the price shock of an IAE. However, suppliers determine the types of contract they offer on a

⁶ CUSC modification proposals, modification reports and representations can be viewed on the National Grid website at <http://www2.nationalgrid.com/uk/industry-information/electricity-codes/cusc/the-cusc/>

⁷ As set out in Standard Condition CL 5(5) of NGET's Transmission Licence, available at: <http://epr.ofgem.gov.uk>

⁸ <http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/CUSC/Modifications/CMP244-and-CMP256/>

commercial basis and in response to the requirements and risk appetites of customers in the market. Therefore, it is not clear that competition is distorted by IAE costs and consequently unclear how CMP267 would create a more level playing field and better facilitate competition.

Impact of IAEs on generator competition

The FMR also states that generator profitability is affected where BSUoS charges increase after generators have already sold power for the relevant season. The FMR suggests that generator risk premiums “could” affect the merit order and thus distort competition. However, in the absence of evidence or analysis in the FMR, it is impossible to quantify, and therefore difficult to assess, the potential benefit of CMP267 to competition in electricity generation.

Impact of IAEs on consumers

The report also argues that customers on passthrough (variable price) contracts unfairly bear the full risk of BSUoS increase from IAEs, whereas most consumers on non-passthrough (fixed-price) contracts will not see IAE cost unless their contracts are up for renewal. However, customers are able to choose what type of contract to enter into (passthrough or non-passthrough), depending on their appetite for risk. Furthermore, customers on fixed-price contracts pay risk premiums to cover possible shortfalls in case of higher than expected BSUoS. These premiums are paid whether or not an IAE occurs. Under CMP267 these customers, having contributed to the cost of the IAE through the risk premium, would potentially be charged again through deferred recovery of charges.

Deferral of cost recovery and timing of an IAE request

Irrespective of these considerations, we are not convinced that that CMP267 would have any significant impact in lowering the risk premiums applied by market participants (suppliers or generators). Consequently, it seems unlikely that there would be any reduction in costs for consumers, or that CMP267 would further promote effective competition in the generation and supply of electricity.

While National Grid is required to raise an IAE as soon as practical, there are circumstances under which it would not be practical until after the costs have been recovered.⁹ At this point any shock to the market would already have been felt. CMP267 would also not capture any unforeseen BSUoS increases that do not qualify as an IAE. Therefore, while CMP267 may capture and defer recovery of some IAEs, the possibility of a significant, short-notice increase in BSUoS would remain.

In light of this, it seems likely that market participants would continue to draw up contracts and risk premiums on the basis that an IAE, or some other event, could increase BSUoS charges with limited notice. As such, we do not consider that CMP267 would address the concerns raised in the FMR in relation to competition or consumer costs.

Conclusion

In conclusion, we consider CMP267 to be neutral to this objective. We are not wholly convinced by the arguments advanced in relation to the impact of IAEs on competition, although we do recognise that higher risk premiums may result in higher costs for consumers overall. In any case, we do not consider that the proposed modification will

⁹ Under the BSIS, National Grid may submit a request for an IAE up to 3 months after the end of the charging year.

have any significant impact in lowering risking premiums because IAE rules mean that the proposed mechanism will not lower the risk of price shocks. Therefore, we do not consider that CMP267 would better facilitate competition.

(b) 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 connect and manage)

The majority of the Panel considered CMP267 to be neutral to the objective of ensuring (as far as reasonably practicable) cost reflective charges. In response to the Workgroup consultation, one stakeholder disagreed, arguing that spreading costs over future years is not consistent with the economically efficient recovery of costs in the periods in which they occur. This view was shared by two Panel members.

We note that deferring cost recovery and smearing it over a longer period may potentially impact on the cost reflectivity of charges. However, we do not consider that these effects would necessarily be significant in the case of CMP267. On balance, therefore, we do not consider that CMP267 would better facilitate this objective.

BSUoS volatility

While we do not consider that CMP267 better facilitates the relevant CUSC objectives, we see some merit in the argument that BSUoS volatility (and the greater uncertainty that may imply) is likely to result in higher risk premiums and therefore higher costs to customers. We, therefore, agree that there is a case for analysing the merits of reducing BSUoS volatility.

Decision notice

In accordance with Standard Condition C10 of NGET's Transmission Licence, the Authority has decided that modification proposal CUSC CMP267: *'Defer the recovery of BSUoS costs, after they have exceeded £30m, arising from any Income Adjusting Events raised in a given year, over the subsequent two charging years'* **should not be made.**

Mark Copley

Associate Partner – Wholesale Markets

Signed on behalf of the Authority and authorised for that purpose