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Dear Andrew,

Response to Consultation on TNUoS Revenue Collection Risk

This response is on behalf of NGET, the onshore electricity transmission owner in England and Wales. It is not confidential.
The rationale and details of proposed implementation provided in the consultation are helpful in identifying the relevant issues. Overall, and in-line with our response to the earlier consultation[1], we agree there could be benefits for customers from lower costs if parts of the TNUoS revenue collection risk is transferred from the ESO to Transmission Owners. This is because the ESO costs to establish an additional working capital facility can be expected to be larger than the TO costs to rearrange finances and ensure the necessary reserves are accessible. Our comments and suggestions are in the following areas:

a) The pros and cons of a wider allocation of the revenue collection risk to all new TOs (future OFTOs & CATOs) rather than just existing onshore TOs.

b) The arrangements that might most effectively manage TNUoS bad debts.

c) The merits of revising the interest charges for revenue under or over recoveries that are currently part of the K mechanisms in TO licences.

d) The nature of ESO incentives that would reassure TOs and end-consumers that TNUoS tariffs are accurately set and billed.

Given these considerations, and to facilitate a transfer of the revenue timing risk to just onshore TOs in the RIIO-2 period as proposed in the consultation, we suggest:

- Minimising the potential for increases in K to arise by requiring the ESO to provide TOs with management information concerning appropriate accruals for TNUoS charge reconciliations.
- Implementing ESO incentives which ensure unbiased forecasting of the TNUoS charge base and which increase action if under or over recovery of TO K persists across multiple years.
- The interest allowed/required for recovery/return via K should be reviewed to ensure it reflects the efficient cost of carrying the revenue timing risk (i.e. without penalties for factors beyond TO control).

[1] RIIO-2 methodology for the Electricity System Operator – decision and further consultation, Ofgem, Aug 2019

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- An upfront allowance to cover the lost opportunity to optimise TO finances that would otherwise have been made. This allowance might automatically adjust to reflect the proportion of total TNUoS variation being allocated to each onshore TO as this could disproportionately increase with certain transmission developments including the expected substantial growth of offshore wind and associated offshore transmission. It might be appropriate to set this total allowance to reflect a specific discount (e.g. 50%) of the £7-8m per year cost previously deducted from NGET allowed revenues for this issue.

Responses to the specific consultation questions are also given below.

a) <u>The TOs subject to revenue collection risk</u>

The reasons set out in the consultation for allocating the TNUoS collection cashflow timing risk to just the onshore TOs (NGET, SPT & SHE-T) are:

- Onshore TOs represent the largest portion of required TNUoS revenues whereas OFTOs currently represent ~10%;
- It would give consistency between onshore TOs and other network utilities (e.g. EDNOs) which have a K factor and incur revenue collection risks;
- It would avoid the disadvantages of reopening existing OFTO revenue determinations; and
- It would maintain consistency between future and current OFTOs.

In relation to the first bullet, the portion of OFTO revenues is likely to increase significantly in the future. The need to decarbonize the UK economy and meet net-zero targets may require a significant increase in transmission which could be provided by new OFTOs and CATOs. For example, the latest ESO tariff forecasts include a view that OFTO revenues may increase to around 20% of total TNUoS over the next 5 years. This trend could continue and accelerate. For example, the Government's Offshore Wind Sector Deal anticipates up to 30GW of offshore wind by 2030 and the Climate Change Committee suggests 75GW might be needed by 2050 to achieve net-zero.

Allocation of the TNUoS revenue collection timing risk to just the existing onshore TOs means these companies could face increasing cashflow volatility as the revenue variations for a growing transmission sector is focused on a shrinking portion of the revenues. This brings a risk that the recognition and adjustments for this risk could lag the increase.

Allocating the risk to all new OFTOs and CATOs together with onshore TOs in proportion to allowed revenues would mean each company's revenue volatility would remain proportionate to their size of activity (assuming other charge volatility factors remain the same). This would have the following advantages:

- It would make it easier for recipient companies to know the nature of the future risk and minimize the cost of adjusting their finances to address it.
- It would improve comparability on cost of capital between competitively appointed TOs and onshore RIIO regulated TOs.

However, given the various changes in prospect for the industry, we accept this risk would be more difficult to assess for a 25 year period (for OFTOs/CATOs) than for a 5 year period (for RIIO regulated companies). This suggests the following alternative risk allocations:

Revenue timing risk allocation:	**Cost impacts - current risk**	**Cost impacts - future risk with more OFTOs and CATOs**
1) With ESO (as now)	Most expensive due to need to establish additional ESO working capital facility. However, the risk would be allocated to the party best placed to manage some aspects.	ESO costs likely to increase as various variability factors apply to a larger total TNUoS revenue requirement.

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2) With onshore TOs (as proposed in the consultation)	Lower cost than 1) by reducing the size of the ESO additional working capital facility.	TO costs will increase as larger revenue adjustments must be accommodated. Should be cheaper than 1) until synergies within TOs are exhausted.
3) With all TOs (including new OFTOs and CATOs but excluding existing OFTOs)	Currently unknown impact on new OFTOs and CATOs but probably more difficult to arrange project finance.	Stable share of risk per TO. (But all TOs exposed to other issues affecting revenue recovery).
4) Onshore TOs carry risk proportional to their revenues. Remaining portion carried by ESO.	Costlier than 2) but cheaper than 1) because ESO has some exposure to timing risk and will need some additional finance facility.	Risk allocation per onshore TO is proportionate to their activity (and so the cost efficiency compared to new finance facility is assured). OFTOs and CATOs remain unexposed as per existing OFTOs.

To compare alternatives 2) and 3) requires information about the impacts of the risk on future OFTO/CATO competitive offerings. A policy to allocate the risk to all new OFTOs and CATOs would discover this information in future competitions and improve comparability between competitive offerings and onshore TOs. However, such a policy would have other implications in practice (covered in the consultation and above) and a decision to pursue the proposed alternative 2) would be pragmatic but result in reducing comparability between competitive and RIIO regulated companies over time.
Alternative 4) offers a similar efficiency benefit for consumers as alternative 2) today but limits the risk that TO revenue management costs might increase as disproportionate allocations progress. It would permit consistent arrangements for new OFTOs and CATOs with existing OFTOs and avoid aspects that may reduce the viability of alternative finance arrangements. It would also mean the ESO would have an enduring financial exposure to revenue recovery, helping incentivize the areas where it can take improving actions. However, in the event of a rapid expansion of OFTO and CATO revenues, it would not make an appreciable saving compared to alternative 1) and not address the other issues raised in the rationale for the proposed approach.
Based on the above, we can see the transfer of the timing risk to just the existing RIIO regulated onshore TOs (as proposed in the consultation) is a pragmatic approach to reducing costs that will fall to consumers. To facilitate this, we suggest:

- The removal of interest penalties associated with any necessary use of K (see below); and
- A recognition that onshore TOs are likely to face significant increases in revenue uncertainty during the RIIO-2 period (for example, due to new OFTOs for already contracted expansion of offshore wind), and this will reduce opportunities for TOs to otherwise optimize their finances.

b) <u>Management of bad debts</u>
We agree with the position in the consultation document that the regulatory treatment of bad debt should not be changed. Transfer of the revenue impacts of bad debt to TOs would severely weaken the prospect of pursuing such debtors and this would not be in consumer's interest.
To achieve the proposed position implies that it must be the shortfall in invoiced revenues rather than a shortfall in collected cash which is transferred from the ESO to TOs.
TNUoS charge invoices are currently subject to later revision as supplier notifications of intended use of system are reconciled with measurements of actual use with settlement data available up to 14 months after relevant use takes place. We understand ESO currently makes accruals for expected adjustments to avoid a K adjustment that would be reversed the following year. It would be beneficial for the ESO to

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provide management information to TOs permitting such accruals to continue and so avoid the potential for otherwise increasing adjustments via K.

c) Revision of interest rates associated with K

As TO's subject to revenue timing risk will not control the charges levied on network users, the current penal interest arrangements associated with the K term in TO licences would not serve a useful purpose. Penal interest rates would not provide an actionable incentive to improve accuracy of customer charges. They would increase the risk that the cost of carrying a potentially increasing revenue timing risk will not be covered by an efficient allowance for the revenue timing management service. Based on this, we suggest the penal interest features are removed from TO licences.
We would welcome a review of the various interest allowances in the price control formulae as part of the RIIO-2 price review to ensure they are suitable for any new responsibilities and allocation of risks. However, an appropriate interest rate in the K mechanism is necessary but not sufficient to cover the efficient costs of accepting the cashflow risk. As identified above, an upfront allowance for the TO lost opportunities to optimize finances when accommodating the risk should also be made.

d) ESO TNUoS collection incentives

Transmission licences state the licensee must use its 'best endeavours' to ensure that Regulated Transmission Revenue does not exceed Allowed Revenue in each year. This strong legal obligation to minimize the risk of a revenue over-recovery is supplemented by the financial incentives provided by disadvantageous interest rates associated with K. The proposed removal of K from the ESO licence and transfer of the revenue timing risk to TOs would weaken ESO financial incentives to avoid aiming low in charge setting. Moreover, it is possible that other ESO incentives (e.g. associated with increasing customer satisfaction) might exacerbate such a tendency. Replacement incentives to encourage accurate charge setting should have a strength consistent with accurate and unbiased charge setting. We suggest the ESO incentives should include:

- symmetrical incentives to minimize forecast error on the TNUoS charge base; and
- incentives that expose the ESO to the time aggregate of TO notified K (so that stronger signals result as under or over-recovery of allowed revenues persist).

Our responses to the detailed questions are as follows:

1. If the TNUoS cashflow timing risk is allocated to the onshore TOs, are there any other interactions we need to consider or aspects that should be taken into account in our RIIO-2 determinations?

See discussion above for:

- The potential for growth in OFTO and CATO allowed revenues to increase the TNUoS timing risk focused on onshore TOs and reduce the opportunity for financial optimisations that would otherwise be possible.
- The potential to reduce the costs that would be incurred by TOs by reviewing interest rates and removing penal elements associated with K.

2. Do you agree that appropriate incentivisation of the ESO for accurate forecast and tariff calculations can be maintained through licence obligations and the ESO's incentives scheme?

We agree that, in principle, ESO incentives to accurately forecast the charge base and calculate the tariffs could be established. We have suggested features that might give suitable incentives to the ESO in this respect and also identified additional management information from the ESO that would be beneficial.

3. Are the proposed licence and code modifications the most appropriate way to move TNUoS cashflow timing risk from the ESO to the onshore TOs?

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We have no comments on the proposed licence and code modifications at this stage but note that certain definitions may need to be updated to ensure correct operation, particularly in extremes if revenues need to be returned from TOs to ESO.

4. Is there any alternative/improved method of reallocating the TNUoS cashflow timing risk from the ESO to the onshore TOs, that you think should be considered?

We support using transmission owner allowed revenues as the basis for allocation of any under or over recovery of revenues. This is a suitable measure of company activity and avoids potential unwanted incentives that could result from a sharing based on RAV or investment.

5. Do you think any other considerations or changes could be required to accommodate the reallocation of this risk?

See above concerning adjustment of the TO K mechanism.

Yours sincerely,

Chris Bennett
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