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NGESO's written representation in respect of CMP342 and the appeal of CMP342

Dear Andrew,

Following your letter to industry dated 2nd November 2020 asking for written representations on CMP342 and the appeal by Muirhall Energy, this letter is to provide additional information to support you in making your decision in respect of CMP342.

The purpose of CMP342

We raised CMP342 following discussions with Muirhall Energy to provide clarity to industry on the inclusion of VAT in calculating the level of financial security that needs to be provided to NGENSO under the provisions of the CUSC. The CUSC contains various financial security provisions to protect industry and consumers in the event of termination or default by an industry party. These provisions exist in relation to the following;

1. Termination amounts for Transmission Connection Asset charging - CUSC Section 2, Part III
2. Security for TNUoS and BSUoS charges - CUSC Section 3, Part III
3. Cancellation Charges for generator and interconnector connections terminating pre-connection (User Commitment) - CUSC Section 15, Part 3
4. Final Sums payments for demand connections terminating pre-connection (Final Sums) - CUSC Schedule 2, Exhibit 3.

CMP342 is solely aimed at providing clarity on the approach and does not look to change the methodology, amount secured, data sources or processes by which these financial security requirements are currently calculated (i.e. CMP342 will have no monetary impact on any industry party). As such, it was deemed to be a 'housekeeping' modification by internal NGENSO teams and so suitable for Self-Governance. This is described in more detail later in this letter.

As Muirhall Energy's concerns relate to the User Commitment methodology, this is where our written representation will focus. We would also note that the CUSC is subject to open industry governance and so any CUSC member may raise a proposal to change these financial security requirements at any time.

User Commitment methodology and process

With new connections, there is always a risk that the connection will not materialise and so any costs associated with that connection will be stranded. Prior to CMP192, 'Final Sums' were used and all stranded costs were recovered from the terminating party. Given the potential size and volatility of such costs, this was seen as a barrier to entry and so CMP192 introduced the 'User Commitment methodology' the effect of which is that the stranding risk is shared proportionally between the generator and consumers. Both the Final Sums methodology and User Commitment

methodology require financial security from the generator to mitigate against its liability should the generator terminate. This liability includes the level of VAT associated with these costs and so the security cover also includes the amount of VAT. The cancellation charge payable is made up of 2 components – the attributable charge and wider works charge. The attributable works charges are based on the actual cost of works, the wider charge is a generic charge based on the MW of the project. A certain proportion of this liability then has to be secured by the generator. A detailed explanation of how the generator’s liability is calculated is provided in Annex 1 at the end of this letter.

Securing Liability

The generator’s total liability (the combination of the liability for the Attributable Works and Wider Works described in Annex 1) will be due from the generator should they terminate their connection and this value is shown in the statement (in the form of CUSC Exhibit MM1) issued every 6 months where the generator does not meet the required credit rating. NGESO requires financial security from the generator by reference to the figure in the relevant MM1 from the initial signing of the connection agreement until the agreements are terminated and any liability is paid.

The financial security required is a proportion of the combined total of the Attributable Works liability and Wider Works liability; this proportion is dependent on a several factors that are shown in the table below.

| Time until energisation | Connection Type | Planning Consent Status | Securitisation Percentage |
|---------------------------|-------------------------|-------------------------|---------------------------|
| Pre Trigger [^] | All | All | 100% |
| Post Trigger [^] | Transmission Connected | Not granted | 42% |
| | | Granted | 10% |
| | Distribution Connected* | Not granted | 45%* |
| | | Granted | 26%* |

* Different proportions were introduced for distribution connected generators as part of CMP223.

[^] The ‘Trigger Date’ is a defined date in each construction agreement, calculated in accordance with CUSC, and is generally the 1 April which is three financial years before connection.

Using the values from Annex 1 for our example generator and assuming it is a transmission connection with planning consent, the amount of financial security required from the generator would be calculated as follows:

$$\text{Security (Exc VAT)} = (\text{Attributable Works Liability} + \text{Wider Works Liability}) \times \text{Securitisation \%}$$

$$\text{Security (Exc VAT)} = (£35,000,000 + £718,707.75) \times 0.1$$

$$\text{Security (Exc VAT)} = £3,571,870.78$$

$$\text{Required Security (inc VAT)} = \mathbf{£4,286,244.93}$$

All the values used in the User Commitment and Final Sums process to calculate the charge are exclusive of VAT but VAT is payable on the charge. An amount equivalent to the VAT, given VAT is payable on the charge, is then added to this figure for the purposes of calculating the level of security required. This total is then shown as the figure to be secured (the ‘Cancellation Charge Secured Amount’) in the statement for this (CUSC Exhibit MM2) issued every 6 months with the MM1. Adding the VAT element is a long-established practice as can be seen from attachment 1 (a Final Sums statement from 2006). This means the final amount our example generator would have to secure is **£4,286,244.93 assuming 20% VAT.**

Once the final value of financial security is calculated and communicated via the Exhibit MM2, it is open to the generator to decide which method of security it wants to provide from options in CUSC (cash, letter of credit or a parent company guarantee being the main forms). The required amount is the same regardless of the form of security

that is selected. In this instance, our example generator would have to provide £4,286,244.93 regardless of whether this financial security is provided as cash, a letter of credit, a parent company guarantee or a combination of these.

As of July 2020, NGESO holds financial security for Cancellation Charges totalling £116m; this value is made up of various forms of financial security as shown:

- Cash held in Escrow: £20m
- Insurance Bond: £2m
- Company meets CUSC required credit rating: £13m
- Letter of Credit: £62m
- Parent Company Guarantee: £19m

In respect of Muirhall Energy more specifically, the User Commitment methodology has been consistently applied to their projects since they accepted their first connection offer for [REDACTED] - the associated MM1 and MM2 statements for this are included as attachment 2. [REDACTED]

During the biannual User Commitment refresh in [REDACTED]

Following this, NGESO sought to ensure absolute clarity for the parties, that in line with the practice, the security requirement included the VAT element of the charge and the template of the Exhibit MM2 was changed; previously it showed figures including and excluding VAT but the clear intention was that the figure representing the cancellation charge secured amount was the one including VAT. Attachment 4 shows the most recent letter and statement for [REDACTED], which shows the change to MM2. This change was to the master template and so all customer statements now follow this revised format. This is consistent across Muirhall Energy's other projects, however the values involved will be different.

Self Governance CUSC change process

All CUSC Modification Proposals can follow standard governance (Ofgem make the decision) or, providing certain criteria are met, self-governance (CUSC Panel make the decision). The Self-Governance Criteria is defined in Section 11 the CUSC as:

“a CUSC Modification Proposal that, if implemented, (a) is unlikely to have a material effect on:

(i) existing or future electricity consumers; and

(ii) competition in the generation, distribution, or supply of electricity or any commercial activities connected with the generation, distribution or supply of electricity; and

(iii) the operation of the National Electricity Transmission System; and

(iv) matters relating to sustainable development, safety or security of supply, or the management of market or network emergencies; and

(v) the CUSC's governance procedures or the CUSC's modification procedures, and

(b) is unlikely to discriminate between different classes of CUSC Parties;

c) other than where the modification meets the Fast Track Criteria will not constitute an EBGL Amendment.”

CMP342 was presented to the May 2020 CUSC Panel and the Panel agreed that this Modification met the Self-Governance Criteria and could proceed directly to Code Administrator Consultation. The appellant attended this part of the meeting.

The Code Administrator Consultation was open to any industry party and the appellant responded to this Code Administrator Consultation and, as part of their response, challenged the May 2020 CUSC Panel's decision that CMP342 met the Self-Governance Criteria.

The responses to the Code Administrator Consultation, including the concerns raised by the appellant in their Code Administrator Consultation response, were considered by the July 2020 CUSC Panel. Due to the concerns raised by the appellant in their Code Administrator Consultation response, the July 2020 CUSC Panel postponed their decision on the modification and sought further clarity from the ESO on when a party would be liable for VAT and to whom. They also agreed to consider if the self-governance route remained appropriate.

Having reviewed the position the CUSC Panel were content to maintain their view that CMP342 met the Self-Governance Criteria. The CUSC Panel made their decision on CMP342 at the August 2020 CUSC Panel. The appellant was present at both of these meetings.

The treatment of Value Added Tax (VAT) by CUSC and recovery of VAT by NGENSO

The CUSC does not extensively document the requirements for VAT, however, there is one reference in relation to User Commitment and VAT (CUSC Section 15, Part 2, paragraph 1.2) which states "Value Added Tax will be payable on any Cancellation Charge". Whilst Section 15 is silent on whether the VAT element of any Cancellation Charge should be included or excluded from the secured amount, we strongly believe it should be included as:

1. If an amount which is due on termination includes VAT, but this is not included when determining the amount of security cover, an element of the security still has to be allocated to VAT (this applies irrespective of how the security has been calculated). This is shown in attachment 5 (see 'Security' and 'Security Forfeited').
2. Not including VAT in the secured amount increases the risk to consumers and industry since it reduces the amount NGENSO can draw upon in the event of termination and non-payment of the Cancellation Charge. This would lead to a higher amount needing to be recovered from consumers and industry. To maintain the current position, a higher Securitisation Percentage would be required to cover the same risk to consumers and industry.

Attachment 5 illustrates this in more detail but by way of example, assume the generator Cancellation Charge liability is £1,000 plus VAT, and they are required to secure 100% (i.e. pre-trigger). If the generator only provides security for £1,000 (i.e. 100% of the VAT exclusive amount) and then defaults, it leaves a payment of £200 outstanding.

Whilst NGENSO can claim the VAT element of this (£33) back from HMRC under the VAT bad debt relief rules, this results in a shortfall of £167 to be recovered from consumers and industry (as shown in scenario (B)). Under the current approach (scenario (A)), there would be no risk to consumers and industry as the payment outstanding (default amount due) is £0. For this position to be maintained, security calculated on the VAT exclusive amount would need to increase to 120% to cover the same risk (as shown in scenario (C)).

Regardless of the approach, the VAT impact should remain the same (as shown in blue under scenarios A to C where the VAT nets to nil). The key difference being the level of risk to consumers and industry.

3. This is the approach that NGENSO has always applied, even before CMP192 when generators had to secure 100% of the stranded cost risk – to have excluded VAT would have resulted in generators securing less than 100%.
4. In all the years NGENSO (or NGET prior to legal separation of the ESO) have applied this practice of including VAT in the amount to be secured, Muirhall Energy is the only party to formally challenge this – despite hundreds of connection applications in this time.

Impact of approving or rejecting CMP342

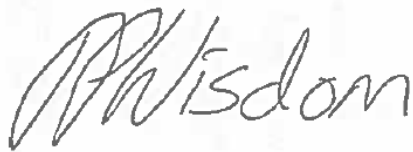
As stated at the beginning of this letter, CMP342 is a clarification of existing and well-established industry process; the approval of which would provide certainty and clarity to industry to ensure they are able to source a suitable financial arrangement to meet their CUSC obligations.

By rejecting this proposal, there is a potential Pandora's box of challenges that are likely to occur. The direct impact of rejecting this proposal is the certainty described above will not be provided and this situation will remain ambiguous. Without a very clear direction from Ofgem within the decision notice, we would expect a legal challenge to be brought either against the CUSC (via a new CUSC modification) or a connection agreement via a dispute which will open the door for additional risk to be passed on to industry and consumers than was approved under CMP192.

If VAT was no longer to be included in the calculation of secured amounts, it would transfer a significant financial risk from individual users to become socialised by industry and consumers as well as question whether VAT should be secured in other areas of CUSC such as TNUoS or BSUoS.

I hope this written representation has been insightful and look forward to seeing the other written responses from industry. We are happy to provide any additional information where needed to help with your decision on CMP342. If you have any questions with regards to this letter, or CMP342 more generally, please raise these with Grahame Neale (grahame.neale@nationalgrideso.com) in the first instance.

Yours sincerely

A handwritten signature in black ink that reads "Jonathan Wisdom". The signature is written in a cursive, flowing style.

Jonathan Wisdom
Commercial Codes Manager

Annex 1 – Detail of User Commitment methodology

As mentioned previously in this letter, the User Commitment methodology balances the risk of termination between the generator¹ and consumers. This balance of risk is dependent on numerous factors and this Annex 1 explains what factors are. Further information is available in CUSC Section 15² or our guidance document³.

Attributable Works Liability

Attributable Works are reinforcement works between the Generator's connection point and the Main Integrated Transmission System (MITS); this means each piece of work (or scheme) can be directly linked (or attributed) to the generator's request for a connection. The proportion of each scheme's total cost that the generator is liable for is calculated as follows:

$$\text{TO Spend} \times \text{SIF} \times (1 - \text{LARF}) \times \text{Distance Factor} = \text{Attributable Liability}$$

Where:

TO Spend = The cumulative value the Transmission Owner has spent or committed to spend to build that specific scheme, for example, £100m. This is also the value NGENSO will be liable to the Transmission Owner for under the STC (System Operator Transmission Owner Code) should the scheme become stranded.

SIF (Strategic Investment Factor) = the proportion of the investment that the generator has triggered. This factor ensures the generator isn't liable for more than their proportion should the Transmission Owner build a component with greater capability than the generator requires. For example, if the scheme has a capacity of 200MW and the generator is 100MW, the SIF would be $100/200 = 0.5$

LARF (Local Asset Reuse Factor) = the LARF is an estimate (provided by the Transmission Owner) of what percentage of the scheme (for example 30% or 0.3) could be reused, should the generator cancel their connection. This percentage is an average representation of the ability to reuse any part of the scheme over the whole of the construction period and therefore does not change.

Distance Factor = Where the nearest suitable MITS is not the connection MITS, the distance factor will be the pro rata share of the transmission capacity to connect the generation project to the nearest suitable MITS on the transmission network. For onshore connections, the nearest suitable MITS and connection MITS are rarely different and so a value of 100% is used where they are the same.

Attributable Liability = The value to be recovered from the generator should they terminate in respect of that specific scheme.

Assuming the generator only has 1 scheme and the example values listed above are used, this means the generator's liability would be:

$$\text{Attributable Liability} = \text{£}100\text{m} \times 0.5 \times (1 - 0.3) \times 1 = \text{£}35\text{m}$$

¹ For clarity, the User Commitment methodology also covers interconnectors and pumped storage, but it does not cover demand connections, which still use the 'Final Sums' method.

² <https://www.nationalgrideso.com/document/91416/download>

³ <https://www.nationalgrideso.com/sites/eso/files/documents/CUSC%20Section%2015%20%28CMP192%29%20-%20Guidance%20and%20Implementation%20Document.pdf>

As this liability is directly linked to the spend of the Transmission Owner, a forecast of this liability is available to generators and is commonly referred to as a 'S-curve'.

Wider Works Liability

In the context of User Commitment, Wider Works is used to describe reinforcement works that are within the MITS network. As it is difficult to associate proportions of investment to specific generators, a £/MW charge is applied and then a modification percentage also applied depending on how close the contracted connection date is. The percentages that are applied are as follows:

| Time until energisation | Percentage applied |
|--------------------------------------------------------|--------------------|
| Same financial year (Y) | 100% |
| Next financial year (Y + 1) | 75% |
| Y + 2 | 50% |
| Y + 3 | 25% |
| Y + 4 and longer (Pre Trigger Date[^]) | 0% |

[^] The 'Trigger Date' is a defined date in each construction agreement, calculated in accordance with CUSC, and is generally the 1 April which is three financial years before connection.

These £/MW charges, a description of how they are calculated and forecast for future years are documented in 'Wider Cancellation Charge Statements' that are published annually and available on our website. The 2020/21 statement is available on our website⁴.

As an example, a 100MW generator located in zone T2 (where the £/MW charge is £9,582.77) that is connecting next financial year (Y+1) would face a Wider Works Liability as follows:

$$\text{Wider Works Liability} = \text{Generator Capacity} \times \text{Zonal Value} \times \text{Percentage} = 100 \times \text{£}9,582.77 \times 75\%$$

$$\text{Wider Works Liability} = \text{£}718,707.75$$

⁴ <https://www.nationalgrideso.com/document/162256/download>