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| Modification proposal: | Connection and Use of System Code (CUSC) CMP251: Removing the error margin in the cap on total electricity transmission charges recovered by generation and introducing a new charging element to ensure compliance with European Commission Regulation 838/2010 (CMP251) | | |
| Decision: | The Authority ¹ has decided to reject ² this modification proposal | | |
| Target audience: | National Grid Electricity Transmission PLC (NGET), Parties to the CUSC, the CUSC Panel and other interested parties | | |
| Date of publication: | 17 August 2018 | Implementation date: | n/a |

Background

European Commission Regulation (EU) 838/2010 (**'the Regulation'**) requires annual average transmission charges paid by generators in Great Britain to be within the range of €0 - €2.5/MWh (**'the permitted range'**). If, in any given year, the annual average transmission charges paid by generators do not fall within the permitted range, National Grid Electricity Transmission plc (**'NGET'**) risks being non-compliant with the Regulation.

CMP251 proposes to replace the error margin used to calculate how much should be recovered from generator Transmission Network Use of System (**'TNUoS'**) charges and replace it with an ex-post reconciliation process.

Under existing arrangements, the proportion of aggregate annual TNUoS charges is split between generators and demand users in such a way as to mitigate the risk that the upper limit of the permitted range is exceeded.³ As detailed in section 14.14.5 of the CUSC, charges to be collected from generators is calculated by:

- adjusting the €2.5/MWh upper limit based on a risk margin for forecasting error (**'the error margin'**) and multiplying this by forecast GB generation output for the relevant year. This results in a total figure in Euros; and
- amending the total figure in Euros as a proportion of forecast transmission operator maximum allowed revenue and converting this from Euros to GB Pound Sterling based on forecast exchange rates.⁴

The error margin is set each year by NGET based upon the level of historical error in forecast generation output and forecast transmission operator maximum allowed revenue.

CMP251's proposer, British Gas (**'the proposer'**), is concerned the existing baseline methodology does not entirely remove the risk that the upper limit of the permitted range can be breached. This is because TNUoS charges are set ahead of the charging year based on forecast variables which can be difficult to accurately predict. This creates a risk that average annual charges may exceed the upper limit.

The proposer also raised a concern that the size of the error margin is having a distortive effect by transferring costs unduly from generator to demand users.

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.

³ The existing methodology was implemented by CMP224

⁴ Forecast exchange rates are sourced from the Office for Budget Responsibility (OBR) Spring Forecast.

Interaction with CMP261

The proposer raised CMP251 on 28 August 2015 with the Final Modification Report ('FMR') submitted to us⁵ on 14 October 2016.

Before the CMP251 FMR was submitted to us, CUSC Modification Proposal '**CMP261**'⁶ was raised on 8 March 2016. CMP261 alleged that the upper limit of the permitted range was exceeded in charging year 2015/16 resulting in a total overcharge to GB generators of £119.5 million. It proposed to remedy the alleged breach by requiring that GB generators be paid a rebate, ie by making an ex-post adjustment to the previously-agreed charging arrangements for 2015-16.⁷

CMP251 proposes a similar remedial mechanism to that proposed by CMP261 in circumstances where there is considered to be a breach of the upper limit. However, the modification proposals differed on two main issues:

- CMP261 proposed a one-off change which would apply to charging year 2015/16, whereas CMP251 would, if approved, apply an enduring solution commencing from charging year 2017/18; and
- CMP261 proposed a one-way reconciliation (when generator charges are above the upper limit) to remedy a one-time alleged breach of the upper limit, whereas CMP251 proposes a two-way reconciliation if generator charges exceed, or fall short of, the upper limit.

We deferred our decision on CMP251 until after our decision on CMP261 (and then subsequently the outcome of the appeal by SSE Generation Limited and EDF Energy (Thermal Generation) Limited to the Competition Markets Authority regarding that decision) in light of the areas of overlap between the two modification proposals. In particular, the fact that both proposals required a view to be taken on the interpretation of the Regulation.

In our decision to reject CMP261 and subsequent open letter following this decision⁸, we expressed the view that:

- we consider that the Regulation should be interpreted as setting a maximum level of average transmission charges to be levied on generators, rather than a target level. The €2.5/MWh amount is the upper limit in a range of values between €0 and €2.5/MWh; and
- any rebate to generators should repay only those parties affected by a breach of the permitted range.

We consider these views are relevant to our decision on CMP251 and other methodology changes that propose using future tariff adjustments as a reconciliation mechanism to repay generators in the case of a breach of the upper limit of the permitted range, and, setting charges such that the average generator charge is always equivalent to the upper limit. We will consider any such proposed changes against the relevant objectives but, as new arguments or evidence has not been presented to us, our views currently remain as set out above.

⁵ 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.

⁶ CMP261: 'Ensuring the TNUoS paid by Generators in GB in Charging Year 2015/2016 is in compliance with the €2.5/MWh annual average limit set in EU Regulation 838/2010 Part B (3)'.

⁷ A full description of CMP261 and our decision can be found on: <https://www.nationalgrid.com/uk/electricity/codes/connection-and-use-system-code/modifications/cmp261-ensuring-tnuos-paid>

⁸ A copy of this letter can be found on the Ofgem website here: <https://www.ofgem.gov.uk/publications-and-updates/ofgem-s-views-following-decision-reject-cmp261>.

The modification proposal

CMP251 proposes to ensure that the average generator charge falls within the permitted range, by replacing the error margin used to set TNUoS charges with an ex-post methodology that would reconcile the amount of allowed revenue to be collected from generators annually. To achieve this, an adjustment would be calculated shortly after the end of the charging year and applied to generator TNUoS charges.

The generator adjustment would be undertaken through a rebate or charge depending on whether the total revenue recovered from generators was higher or lower than the target amount. Demand users would be paid the reverse of the adjustment in future years through TNUoS tariff adjustments.

The proposer believes CMP251 would increase the certainty that the upper limit of the permitted range will not be breached, minimise the transfer of costs from generator to demand users, and provide greater predictability of average TNUoS charges for generators and the impact on demand tariffs in future years.

Seven Workgroup Alternative CUSC Modifications (WACMs) were proposed in response to CMP251. These differed from CMP251 in several ways:

- whether reconciliation against the upper limit is one-way or two-way
- the timing and method of reconciliation - whether it is achieved through rebates or tariff adjustments.

The table below shows how CMP251 and its WACMs differ from each other.

Table 1: CMP251 and its WACMs

| WACM number | When is generator charge reconciled | When is supplier charge reconciled | One or two-way reconciliation |
|-------------|--|--|-------------------------------|
| CMP251 | Rebate or charge: May Y+1 | Y+2 tariffs | Two-way |
| WACM 1 | Y+2 tariffs | Y+2 tariffs | One-way |
| WACM 2 | Rebate or charge: May Y+1 | Y+2, Y+3, Y+4 three-year average tariffs | Two-way |
| WACM 3 | Y+2, Y+3, Y+4 three-year average tariffs | Y+2, Y+3, Y+4 three-year average tariffs | Two-way |
| WACM 4 | July Y+1 rebate | July Y+1 charge | One-way |
| WACM 5 | May Y+1 rebate | Y+2 tariffs | One-way |
| WACM 6 | Y+2 tariffs | Y+2 tariffs | Two-way |
| WACM 7 | Rebate May Y+1 Charge Y+2 tariffs | Y+2 tariffs | Two-way |

CUSC Panel⁹ recommendation

At the CUSC Panel meeting on 30 September 2016, a majority of the CUSC Panel members agreed that CMP251 and WACMs did not better facilitate the relevant objectives

⁹ The CUSC Panel is established and constituted from time to time pursuant to and in accordance with section 8 of the CUSC.

and that the baseline better facilitated the relevant objectives than any of the proposed modifications.

Our Decision

In reaching our decision we have considered the issues raised by the modification proposal and the FMR dated 14 October 2016. We have also considered and taken into account the responses to the Code Administrator consultation on the modification proposal which are attached to the FMR.¹⁰ We have concluded that implementation of the modification proposal will not better facilitate the achievement of the applicable charging objectives of the CUSC.¹¹

Reasons for our decision

We consider neither CMP251 nor any of the WACMs identified would better facilitate CUSC objectives (a), (b), (c) and (e) than the baseline, and would have a neutral impact on the other objectives.

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

A majority of the CUSC Panel considered CMP251 and the WACMs did not better facilitate relevant objective (a). A range of views were noted: One Panel member noted that an ex-post solution would be detrimental to competition and lead to higher costs for consumers as market participants will build in risk premia to their contracts. Another Panel member thought CMP251 and the WACMs would better facilitate objective (a). Two Panel members considered WACMs 1, 5, 6 and 7 would be neutral against the objective.

Respondents to the Workgroup and Code Administrator consultations expressed a range of views about the impact on objective (a). One consultation respondent considered that CMP251 would enhance competition as it would remove uncertainty about whether the upper limit has been breached and an adjustment to generator charges is required.

Several respondents considered that CMP251 would reduce competition by making costs and tariffs less predictable. These respondents considered the baseline arrangements better facilitated competition by providing greater charging stability; this would allow market participants to make effective decisions and offer the most competitive rates to their customers.

One respondent also thought that an ex-post solution would mean money would be recovered from a different customer base to that which existed at the time the charge arose. Another respondent considered that an ex-post reconciliation process would damage competition by requiring generators to factor in fluctuations in the exchange rate; this would hinder smaller parties to a greater extent than larger ones, who may have the resources to better manage risk.

¹⁰ CUSC modification proposals, modification reports and representations can be viewed on NGET's website at <http://www.nationalgrid.com/uk/Electricity/Codes/systemcode/amendments/>

¹¹ As set out in Standard Condition C5(5) of the electricity Transmission Licence, see: <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20transmission%20full%20set%20of%20consolidated%20standard%20licence%20conditions%20-%20Current%20Version.pdf>

Our position on CUSC objective (a)

We consider that CMP251 and the WACMs will not better facilitate relevant objective (a) compared to the baseline arrangements. At present, generator charges are set on an ex-ante basis. This provides generators and other users with a degree of certainty over the level of charges they will face. Providing this forward visibility allows transmission system users to incorporate the level of TNUoS charges into their business and investment strategy, lowering risk for these companies and allowing for greater competitive activity.

The ex-post reconciliation processes proposed by CMP251 and the WACMs would increase the tariff and cost uncertainty that transmission system users would face. Transmission system users would not face the level of TNUoS charges or the level of reconciliation that would be required until after the charging year had finished; this would create uncertainty for transmission system users which would be expected to result in more conservative estimates of TNUoS charges being incorporated into their pricing strategies. This could result in higher costs for consumers and be detrimental to competition.

The reconciliation methodologies proposed by CMP251 and the WACMs would also move transmission system user costs between years. CMP251 and many of the WACMs also propose to reconcile generator charges using tariff adjustments. We consider both these elements of the proposals would not facilitate relevant objective (a) as revenue adjustments could be made for different parties than those originally impacted by any potential breach.

(b) that 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 a connect and manage connection);

The proposer considers the error margin applies a cap to the amount of revenue recovered from generators which goes beyond that stated in the Regulation. They consider that this results in an 'unnecessary restriction' on how the cost reflectivity principles are applied to the charging methodology. They stated that CMP251 would minimise the impact of the Regulation and, as a result, better facilitate relevant objective (b).

There was a mixed view from the CUSC Panel on whether CMP251 and the WACMs better facilitated relevant objective (b). Two Panel members considered all the proposed modifications better facilitated objective (b), one considered none of the proposals better facilitated (b). However, most Panel members were neutral on the impact of CMP251 and the WACMs on facilitating objective (b).

Consultation respondents expressed a range of views on how CMP251 and the WACMs would affect relevant objective (b). One respondent considered CMP251 would have little impact on objective (b) as it would only affect the residual elements to the demand and generation charges which are not cost reflective.

Another respondent considered that if the upper limit had been breached (as suggested by CMP261) then a solution which ensures this cannot happen would better facilitate relevant objective (b).

A number of other respondents considered that CMP251 and the WACMs would increase the uncertainty of tariffs and costs to TNUoS payers. They considered that this would

undermine the predictability of tariffs, which they considered could be both detrimental to competition and would not improve the cost reflectivity of the current methodology.

Our position on CUSC objective (b)

We consider CMP251 and the WACMs do not facilitate better objective (b). Any reconciliation required to make sure the upper limit is not breached should make sure that the correct parties are reconciled the correct amount of money.

CMP251 and many of the WACMs propose to reconcile generator charges through tariff adjustments made in subsequent years. Reconciling generator charges in this way would not facilitate objective (b) compared to the existing methodology, in particular the proposals risk that charges or rebates are not targeted at the parties operating in the charging year in question but, instead, are spread across a different transmission system user base. This would not increase cost reflectivity to further facilitate objective (b).

CMP251 and a number of the WACMs propose a two-way reconciliation against the upper limit. Average generator charges would be reconciled if they were above or below the €2.5/MWh upper limit. In effect, this turns the upper limit into a target amount. As we said in our open letter following our decision to reject CMP261, the Regulation should be interpreted as setting a maximum level of average transmission charges to be levied on generators, rather than a target level. If there is a suspected breach of the upper limit, this can be remedied through existing processes on an ad-hoc basis. This includes situations where the average annual generator transmission charge was below the zero lower limit of the permitted range. Existing processes can explore if a breach of the permitted range occurred and identifying which, if any, parties require a reconciliation of charges.

As a result, we consider that CMP251 and the WACMs that propose a two-way reconciliation would not facilitate objective (b) better. WACMs that propose a one-way reconciliation are not impacted by our views arising from CMP261. However, they are subject to consideration against other arguments and relevant objectives contained in this letter.

(c) that, so far as is consistent with sub-paragraphs (a) and (b), the use of system charging methodology, as far as is reasonably practicable, properly takes account of the developments in transmission licensees' transmission businesses;

The proposer considers CMP251 ensures that NGET remains compliant with European legislation and properly reflects its duties in the development of its transmission business. The proposer also considers that CMP251 ensures, compared to baseline arrangements, no consumer detriment through setting generator charges significantly below the upper limit and giving assurances that the upper limit will not be breached.

A number of respondents to the Workgroup and Code Administrator consultations and the entire CUSC Panel considered CMP251 was neutral against relevant objective (c). One respondent considered any solution which sought to ensure there was a prohibition on the upper limit being breached would better facilitate relevant objective (c).

Our position on CUSC objective (c)

In our view, CMP251 and the WACMs do not better facilitate objective (c).

CMP251 was submitted before we made our decision on CMP261. While the timing and interaction of both modifications could not have been foreseen by the proposer, we consider our views expressed in CMP261 and our open letter in regard to our

interpretation of EU Regulation 838/2010 are relevant to CMP251. This includes our view that the upper limit is a maximum level of average transmission charges to be levied on generators, rather than a target level.

As a result, we do not agree that CMP251 and the WACMs reflect developments in transmission licensees' transmission business.

We are aware of the concerns raised by industry in the CMP251 FMR about the effect the error margin is having on generator and supplier costs. We are content with the inclusion of an error margin with the existing ex-ante approach. However, NGET should make sure the size of the error margin – currently 21% - is as low as possible in order to minimise any potential distortion and the transfer of costs between generators and suppliers.

NGET should review its forecasting process and assess if changes can be made to the calculation of the error margin to produce a more accurate and precise adjustment of the upper limit of the permitted range.

(d) compliance with the Electricity Regulation and any relevant legally binding decisions of the European Commission and/or the Agency;

A majority of the CUSC Panel considered CMP251 and the WACMs were neutral against objective (d). One Panel member considered neither CMP251 nor the WACMs further facilitated the objective as the baseline arrangements better promoted cross border trade. Another believed the CMP251 and the WACMs better facilitated objective (d). The two remaining Panel members considered WACMs 1, 4 and 5 better facilitated the objective.

Three consultation respondents referred to the legal analysis requested by the Workgroup which examined CMP251 compliance with the Regulation.¹² One of these respondents considered CMP251 was neutral regarding objective (d) as the legal opinion considered the ex-ante baseline arrangements met the relevant European legislation at least as well as the ex-post approach suggested by CMP251. The other two respondents considered CMP251 did not further facilitate objective (d) for the same reason.

One respondent considered that CMP251 or the WACMs would facilitate objective (d) as it would make sure the upper limit could not be breached.

Our position on CUSC objective (d)

We consider CMP251 and the WACMs are neutral against this objective. Both the baseline arrangements and the methodology proposed by CMP251 or the WACMs would comply with the Regulation by putting in place arrangements to make sure breaches of the upper limit can be remedied.

We note comments that an ex-post methodology could increase the possibility of a breach of the upper limit, but also ensure it is corrected as quickly as possible and would therefore better facilitate objective (d). However, we are content the baseline arrangements seek to minimise the risk of generators charges exceeding €2.5/MWh and, if that does occur, a reconciliation can be carried out via a code modification to reconcile charges if required.

¹² This analysis can be found in Annex six of the FMR.

(e) promoting efficiency in the implementation and administration of the system charging methodology.

The CUSC Panel considered CMP251 and the WACMs either did not facilitate this objective – because an ex-post reconciliation process would increase complexity and may reduce efficiency in the implementation and administration of the charging methodology - or were neutral against it.

Our position on CUSC objective (e)

We consider CMP251 and the WACMs which propose a two-way reconciliation of charges would not better facilitate objective (e). Two-way reconciliation would put in place an annual process to make sure average generator charges are always equivalent to €2.5/MWh. This would be less efficient than the existing approach as it could result in annual breaches of the upper limit which would need to be remedied via annual reconciliations and adjustments to charges.

For this reason, we consider the current methodology, which employs an error margin to reduce the chances the upper limit is breached, and dealing with any breaches through the CUSC modification process, is more efficient than an annual reconciliation process.

Decision notice

In accordance with Standard Condition C10 of NGET's Transmission Licence, the Authority hereby directs that modification proposal CMP251 'Removing the error margin in the cap on total TNUoS recovered by generation and introducing a new charging element to TNUoS to ensure compliance with European Commission Regulation 838/2010' not be made.

Frances Warburton
Director, Energy System Transition

Signed on behalf of the Authority and authorised for that purpose