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TNUoS[1] Revenue Collection Risk

Dear Andrew,

We welcome the opportunity to respond to your **TNUoS Revenue Collection Risk** consultation.

National Grid Electricity System Operator (ESO) became a legally separate entity on 1 April 2019. As the ESO, we use our unique perspective and independent position to facilitate market-based solutions which deliver value for consumers. Our role in managing the billing and settlement activity for TNUoS revenues means that we are currently exposed to the risk relating to any variances between allowed and actual revenue. Whilst we acknowledge that it is in the best interest of consumers for the ESO to retain the TNUoS revenue management and collection function, there may be alternative options for the allocation of the cashflow risk associated with the collection of network revenues that could result in lower costs to consumers. For this consultation to be thoroughly assessed, we have set out our interpretation of the policy intent behind this proposal below and highlight some of the key factors we believe should be considered upon review of this consultation. More information on these points can be seen in our response to your questions appended to this letter.

Key points of our response:

- When considering the reallocation of TNUoS revenue cashflow risk, Ofgem should ensure a robust impact assessment is undertaken, to ensure that any proposed changes realise the largest consumer benefit. We would support a proposal that moves the risk to the party best placed to bear the risk, but any such move should consider where the largest cost saving may be made. We provide further views in our response to question five.
- We support a 'pay when paid' model for TNUoS and believe that the intent of this consultation is that the mechanism would be based on invoiced amounts rather than cash received. We have provided our views in the response to question five.
- We believe that the ESO should retain the revenue collection function. We consider that this approach could also realise consumer benefits as TNUoS will continue to be managed through a single system rather than moving to multiple duplicate systems across each of the Transmission Owners (TOs).
- Moving the cash flow timing risk to onshore TOs[2] does not remove all the financial risk that the ESO is bearing in relation to TNUoS revenue collection. Some of the items that remain with the ESO are determined by ad-hoc activities of third parties and not directly within the ESO's control. These items are not covered in the ESO's base revenue and therefore fall outside Ofgem's Annual Iteration Process.
- We believe that Ofgem's stated intention to formalise the bad debt recovery process is important and, while separate to this consultation, should be progressed in parallel.

We welcome the opportunity to further discuss the points raised within this response. Should you require any further information or would like clarity on any of the points outlined in this response then please contact Laurence Barrett in the first instance at Laurence.Barrett@nationalgrideso.com.

Yours sincerely,

Kayte O'Neill – Head of Strategy and Regulation

Claire Tuckman – Finance Director

[1] Transmission Network Use of System
[2] The consultation defines onshore TOs as National Grid Electricity Transmission (NGET), Scottish Power Transmission (SPT) and Scottish Hydro Electricity Transmission (SHE-T)

Responses to your questions

Q1 If the TNUoS cashflow 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?

Our RIIO-2 business plan[3] extensively discusses the risks associated with the roles we undertake and assesses how these risks are remunerated through the Ofgem proposed RAV x WACC framework. To the extent that we believe roles and risks are not adequately funded through this mechanism, we have looked at several different ways to assess an appropriate level of additional remuneration. Any transfer of risk from the ESO to the onshore TOs would need to be taken into consideration in the assessment of risk and remuneration to ensure that an appropriate level of return is still provided for carrying out the revenue role and managing the residual risks not affected by this proposal. In addition, we would need to assess the impact on the size of our working capital facility, which was sized to include TNUoS collection risk and expires in April 2022. Although the transfer of TNUoS risk under this proposal could significantly reduce the size of facility required, a facility would still need to be funded through the agreed RIIO-2 funding framework in order to manage the remaining cash flow risks.

Q2 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 incentive scheme?

As the ESO, we are the party responsible for setting the tariffs which result in charges being paid to the ESO by suppliers and generators. This means that the amount of any potential over or under-collection is partly within the control of the ESO. However, under this proposal the consequences would only be felt by the onshore TOs. As a result, there would be no opportunity for the party that is proposed to bear the risk to mitigate the risk they would hold, rather the size of this risk would be influenced by the ESO. Whilst there are existing licence conditions requiring the publication of accurate information by the ESO to enable market participants to make efficient operational and investment decisions, we also acknowledge that these participants may consider that additional incentivisation on the ESO is beneficial for ensuring the publication of accurate information. The proposal to add sufficient incentivisation to the ESO is therefore important for all parties.

We acknowledge that the ESO's current incentive framework has broad enough roles to encompass a TNUoS related incentive. However, due to the nature of TNUoS forecasting we consider a mechanistic incentive to be the most appropriate solution. An incentive which includes an upside but retains elements similar to the current penal rates of interest incurred on K[4] values outside a certain threshold (ESO licence Special Condition 3A Part F) may be an effective measure. Other measures as currently set out in the licence regarding over and under recovery in successive years could also be considered as a useful additional incentive (ESO licence Special Condition 3A Part G and Part H).

When considering appropriate incentivisation mechanisms Ofgem should also acknowledge that the ESO relies on data input from industry participants for accurate forecasting and tariff setting. We would therefore suggest that it is sensible to consider incentivising industry parties to provide the required data to the ESO in an agreed format, with an acceptable quality and within the required timescale.

It should also be noted that the TNUoS tariff calculation is defined in the CUSC[5] which is subject to open governance. Currently anyone, at any time, can raise a CUSC modification to change the TNUoS methodology which could result in the previous forecasts being inaccurate. As such, the current open governance approach needs to be reviewed to support certainty of TNUoS forecasts and any associated incentivisation mechanism.

Q3 Are the proposed licence change and code modifications the most appropriate way to move TNUoS cashflow risk from the ESO to onshore TOs?

If it is decided to move TNUoS cashflow risk from the ESO to onshore TOs, then we agree that licence changes and code modifications are the most appropriate way to. However, we consider the proposed implementation date of 1st April 2021 to be challenging. Paragraph 3.4 (iii) of the consultation document states that "licensees shall use best endeavours to ensure the STC[6] modification is in place by 1 April 2021".

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[3] https://www.nationalgrideso.com/about-us/business-planning-riio/riio-2-final-business-plan
[4] The 'K' correction term reflects the difference between allowed and collected revenues
[5] Connections and Use of System Code
[6] System Operator – Transmission Owner Code

Given the number of parties involved and their differing priorities, this timescale may not be achieved through no fault of any particular party and clear guidance should therefore be given by Ofgem on the consequences that this may have.

The proposed changes to the STC suggest that each month the ESO would notify the onshore TOs, via a schedule of revenue, what amounts could be billed for that month. The suggestion is that this notification would be prepared on the 17th day of the month. Although we envisage that we may be able to provide the notification earlier than the 17th day of the month, we are also conscious that the billing process is under review and could change as a result of the Targeted Charging Review (TCR) implementation. It would therefore be prudent to only confirm the date once the billing process outcome is known and approved under CUSC.

We also note that there are inconsistencies and errors in the drafting suggestions included in the consultation document, some of which we have highlighted below:

- Paragraph 3.7 of the consultation document suggests a new paragraph 3A.12 for the ESO licence which would actually be 3A.11.
- The wording at the start of suggested STC paragraph 3.1.6 within 3.14 of the consultation document suggests that only a maximum of the amount owed to an onshore TO according to their revenue schedule would be paid when the intent is that all collections would be payable, including any over-recovery.
- With regard to suggested STC paragraph 3.1.5 within 3.14 of the consultation document, we do not believe that there is any requirement to restate the proportions to onshore TOs on a monthly basis so the schedule of revenues that the onshore TOs submit need only be annual as now rather than monthly.
- Part of the suggested amendment to licence condition B12, detailed in paragraph 3.12, is that the amount payable to onshore TOs should be pro-rata to Total Transmission Charges (when the total of those proportions will be less than 100%). This is inconsistent with suggested STC paragraph 3.1.6 within 3.14 of the consultation document which says that revenue should be shared "proportionate to … total onshore revenue". As noted in our response to question five below, the latter wording is the correct interpretation for the proposal to work as intended.

While we expect that the sharing basis should be clarified, these items (and any others like them) will be resolved during the licence and code modification process.

Q4 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 note that the consultation document does not propose to introduce any OFTO related cashflow timing risk to OFTOs as these are a much smaller proportion of overall revenues (individually, though we note that collectively OFTOs are larger than SHE-T and similar in size to SPT currently). Instead, OFTO related cashflow timing risk will be borne by the onshore TOs. In addition, Ofgem currently considers that CATOs[7] should be treated in the same way as OFTOs.

We acknowledge that if the TNUoS cashflow risk was moved to OFTOs and CATOs, this would run contrary to the assumptions made in the competitive bid stage. However, consideration should be given to the fact that there are currently no CATOs in existence and therefore no financing arrangements have been made for these schemes. Additionally, there is a possibility that any CATOs that do come to exist could become significant in the future, potentially challenging the onshore TOs in terms of their size. We therefore support Ofgem's consideration in paragraph 2.14 of the consultation and the opportunity to consider the approach for CATOs as and when the policy further develops.

Q5 Do you think any other considerations or changes could be required to accommodate the reallocation of this risk?

We have set out below some additional points we believe should be considered when reviewing this consultation.

[7] Competitively Appointed Transmission Owners

Requirement for a robust impact assessment

We believe that a robust impact assessment should be conducted by Ofgem to ensure that the outcome of this consultation delivers the lowest cost to consumers. The proposed reallocation of risk from the ESO to the onshore TOs may be appropriate (due to the relative size of TO balance sheets), but we acknowledge that taking on this risk could result in additional costs for the TOs.

Although we do not comment on the size of these possible costs to the TOs within this consultation, we do believe that Ofgem should assess the overall costs of managing TNUoS cashflow risk across all parties in question. Consideration should be given to the possibility of increased costs to the TOs and how this could compare to the possible costs savings realised by reallocating the risk away from the ESO. Such an impact assessment should ensure that the outcome of this consultation represents the best outcome for consumers.

Regardless of the outcome of this consultation, we support Ofgem's intention stated in 1.6 of the consultation documents to ensure any change are considered in the price control determinations for the ESO and onshore TOs to ensure the party that bears the risk is appropriately remunerated.

Revenues retained by ESO

Our interpretation of the proposed changes is that all revenues collected will be passed over to the onshore TOs on a pro-rata basis. However, the consultation is not clear on this point as the amounts relevant to those onshore TOs do not represent the entirety of TNUoS charges. The proportions that apply to each onshore TO should be relative to the total amount attributable to onshore TOs rather than the total transmission charges. Appendix 1 provides an indication of the breakdown of charges using figures based on the charging year 2019-20. In this table, the amount attributable to the three specified onshore TOs is £2,427m out of a total transmission charge of £2,879m (84.3%). The other parties currently present are OFTOs (£390m) and the ESO (£62m).

It is therefore important to note that some elements of transmission charges will remain with the ESO in order to provide reimbursement of items that the ESO is required to pay on behalf of the entire industry. These include the Ofgem licence fee and Inter-TSO Compensation payments. As such, the ESO needs to be considered as one of the 'other parties' referred to in paragraph 1.4 of the consultation and monies for these items would be deducted from the total as part of the calculation performed to arrive at a figure available for paying to the onshore TOs.

Transfer of TO final sums risk

Upon termination of a Transmission Construction agreement, the ESO is liable to pay the relevant TO a figure equal to the TO's estimate of final sums. In the case of a large connection we estimate that this can amount to up to £100 million. To the extent this differs from the amount billed to the terminating party in accordance with their contract, the ESO would recover this amount through the following year's TNUoS charges. This still presents a considerable cashflow risk to the ESO. Consideration could be given as to whether the onshore TOs would be best placed to hold the cashflow risk and recover costs through their own allowed revenues.

Alternatively, we believe that the ESO would need to retain a K mechanism if this risk was not held by the TOs. Termination Sums (TS) is calculated as the amount paid to the TO less the amount received from the terminating party, operating with a one-year lag. In practice, this means that the amount the ESO seeks to recover in relation to TS is set in the January prior to the start of the charging year. Actual figures are therefore used for the nine months that have passed, combined with a forecast for the three that remain. The actual outturn means that the 'final' figure for TS may be different from the amount used at charge-setting, and this difference is currently one of the contributing items to K.

This also applies to other licence terms which are recovered through TNUoS (such as DIS, the mismatch that is introduced to billing of site-specific connections by differences in the CUSC and STC methodologies). A further change would therefore be needed to achieve the aim of this consultation to remove K completely from the ESO licence.

Annual demand reconciliation process

In a similar vein, not all charging in relation to a charging year currently takes place in that year. Section 3 of the CUSC allows a customer to set their own forecast for the year and be billed based on that forecast, provided that the customer's forecast does not differ from the ESO's forecast by more than 20 per cent. This amount is then 'trued-up' in the reconciliation process after the end of the charging year. For example, Company A forecasts their usage to imply a charge of £120 over the year, so they are billed this and pay £10 each month for 12 months. However, their actual usage implies a charge of £144 across the year. The £24 that Company A still needs to pay is billed, and paid, in the reconciliation process some months later. In line with the CUSC, reconciliation billings also include an element of interest for late payments which could, currently, result in the total receipts for the year exceeding the allowed total, without impacting on K. This also works in reverse, with any potential repayment also including interest. The ability of the ESO to meet this interest liability without having held any of the cash needs to be considered, in particular, in relation to potential changes to the billing and reconciliation process through the TCR implementation.

Pay as 'paid' – cash and invoiced amounts

We understand that the intent of this consultation is that the 'pay as paid' model will be based on the ESO paying invoiced amounts, rather than cash received. We also understand from footnote 13 of the consultation document that Ofgem view the K correction term as distinct from bad debt and that this consultation does not propose to modify the regulatory treatment of bad debt. A 'pay on invoiced' method means that any bad debt risk remains with the ESO.

Whilst we acknowledge Ofgem's proposal for a 'pay on invoiced' approach, it is worth highlighting that if a 'pay on cash received' method was considered as an alternative, this would not transfer any bad debt risk to the onshore TOs. Rather, each onshore TO could receive less cash overall than it was expecting, resulting in an amendment to future year charges through its K mechanism. The result, therefore, would be that no party suffers the entirety of bad debt risk, which is appropriate given the fact that neither the ESO nor any of the TOs would be able to cope with the unlikely scenario of a large customer ceasing to trade. Instead, each invoiced TNUoS party would suffer a small proportion in their charges, although the time lag that would apply potentially means that this could be a different group of parties.

Adoption of a 'pay on cash received' method would fully remove the cash revenue collection risk from the ESO by ensuring that late (or non) payment does not need to be funded by the ESO, however, we also acknowledge that this adds complexity by introducing the need to record cash receipts and the charging year to which they relate. For example, cash received from a liquidation distribution may take place several years after the period referred to in the original invoice but would only be available for paying to onshore TOs at that point.

Under a 'pay on cash received' approach, it could be perceived that there would be a lack of incentive for the ESO's credit control function to collect the amounts invoiced. As a result, there could be an increase in the level of late payment or default, the effect of which would be felt, albeit temporarily, by the onshore TOs but not by the ESO. This also creates a problem where the amount outstanding at any one time is only felt in part by each of the three onshore TOs, none of whom raised the invoice in question. None of these parties would therefore be able to affect the size of the risk, or control when it might crystallise, in any way. This suggests that 'pay on invoice' would be the best way to proceed, a solution which leaves the ESO holding the bad debt risk (and still requiring a WCF sized to accommodate this). As such, we believe that Ofgem's stated intention to formalise the bad debt recovery process is important and, while separate to this consultation, should be progressed in parallel.

A 'pay on invoiced' approach also ensures that the timescales for payment of amounts from the ESO to onshore TOs could remain as they currently are (i.e. 15th of each month). Moving to a 'pay on cash received' approach introduces a delay to those timescales to allow the cash to be received before the onshore TOs' invoicing process can commence. Whilst we consider that there are benefits to taking a 'pay on cash received' approach, with a formalised process in place to insulate the ESO from the bad debt risk, we believe that progressing with 'pay on invoiced' is an appropriate solution for this proposal.

Risk environment

In either case, it should also be considered that the change to 'pay as paid' places an additional burden on the ESO. Each onshore TO will take a far more active interest in the activities and processes of the ESO as their cashflows will depend on them. This could result in a significantly increased reporting requirement, greater regulatory involvement and risk and closer scrutiny of the charge-setting process. In the case of 'pay on cash received' it would also introduce a greater oversight of the credit control function.

BSUoS revenue collection

We support Ofgem's proposal to engage with the BSUoS taskforce to ensure the conclusions of this consultation consider the possibility of the introduction of another K factor for BSUoS charges.

Ofgem's Significant Code Review: "The Targeted Charging Review"

There are several CUSC modifications in progress (CMP332, CMP335 and CMP336) that will result in significant changes to the current way demand charges are calculated. Any changes that are brought in will need to be mindful of the effect that they may have on reconciliation amounts in particular. For example, the majority of TNUoS revenue recovery will no longer be on a volumetric basis for demand and will instead be on a site by site basis with a more fixed charging base. The effects of this on the ESO are not yet well understood as the changes have only just begun to be considered. We would urge Ofgem to consider the outcomes of these modifications in light of these proposals.

Appendix 1

Licence Term	Description	Amount (£m)	Amount (£m)	Notes
TRU_t[8]	True up for Inflation that applies to licence terms		3	All currently due to NGET, will change in two years' time
RB_t[9]	*Business Rates*			*To be moved to BSUoS in RIIO-2*
LF_t[10]	*Licence Fee*	*24*		*Remains with ESO*
ITC_t[11]	*Inter-TSO Compensation*	*10*		*Remains with ESO*
$Term_t$	*Amount recovered from parties in respect of terminations*	*4*		*Remains with ESO*
TSP_t	*SPT Maximum Allowed Revenue*	*379*		*This amount is notified by and therefore paid to SPT*
TSH_t	*SHE-T Maximum Allowed Revenue*	*350*		*This amount is notified by and therefore paid to SHE-T*
$TNGET_t$	*NGET Maximum Allowed Revenue*	*1,698*		*This amount is notified by and therefore paid to NGET*
$TOFTO_t$	*Total of OFTO Maximum Allowed Revenue*	*390*		*This amount is notified by and therefore paid to OFTOs (represents the aggregate of all OFTOs)*
$OFET_t$	*Amount paid to distribution companies for connected OFTOs*	*1*		*Remains with ESO*
$TICF_t$	*Interconnector cap and floor adjustment*	*-8*		*This amount is recovered from Interconnectors*
$TICP_t$				*This term has not yet been used*
PT_t	*Pass-through costs to be recovered*		*2,848*	Total of the above italicised lines
NIA_t	Network Innovation Allowance		3	Remains with ESO
$NICF_t$	Network Innovation Competition Fund		32	Paid to innovation competition winners, which may include the ESO, not in proportion to their allowed revenue
DIS_t[12]	Site Specific True Up		-16	Remains with ESO

[8] At the moment, this item is nil as this is the first year of a separated ESO. In two years' time this term will have a value. The figure quoted is that which we expect may be present in two years. The equivalent value in 2019-20 published figures is within the total shown for NGET.

[9] At the moment, this item is nil as this is the first year of a separated ESO. In two years' time this term will have a value. The figure quoted is that which we expect may be present in two years. The equivalent value in 2019-20 published figures is within the total shown for NGET.

[10] At the moment, this item is nil as this is the first year of a separated ESO. In two years' time this term will have a value. The figure quoted is that which we expect may be present in two years. The equivalent value in 2019-20 published figures is within the total shown for NGET.

[11] At the moment, this item is nil as this is the first year of a separated ESO. In two years' time this term will have a value. The figure quoted is that which we expect may be present in two years. The equivalent value in 2019-20 published figures is within the total shown for NGET.

[12] Although £(16) million this year (implying an overcollection last year), this term is expected to be positive (by a similar amount) next year

Licence Term	Description	Amount (£m)	Amount (£m)	Notes
TS_t[13]	Terminations True Up		2	Remains with ESO
FIN_t	ESO funding allowance transferred from NGET		7	Remains with ESO (will be nil in RIIO-2)
K_t	Correction factor in respect of over-or under-collected revenue from two years previous			As the formula is now drafted, this will be ESO K only (the amount of K attributable to TOs will be within their pass-through amounts)
TO_t	Total Transmission Charges		2,879	

Note that this table includes some elements that apply directly to current year charges and some elements that are expected to apply as a result of ESO legal separation (which means the NGET figure would reduce) – it is therefore indicative only rather than a statement of fact.

[13] This year's value for TS is £2m and the amount being built up that will be in next year's charges is around £4m. This could however be very significant depending on the nature of the scheme that is terminating).