Scottish & Southern
Electricity Networks

Andrew Ryan
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

31 January 2020

Dear Andrew,

TNUoS Revenue Collection Risk Consultation

Scottish and Southern Energy Networks (SSEN) welcomes the opportunity to respond to the above consultation. As a GB onshore transmission owner through SHE Transmission plc (SHET), we have an interest in the relationship between ourselves and the Electricity System Operator (ESO). We support working towards a solution which provides the best outcome for consumers and so, have taken the opportunity to respond to the consultation questions tabled in relation to the TNUoS Revenue Collection Risk in an appendix to this letter.

The highlights of our response are as follows:

- There no clear evidence or analysis presented to justify the need to consider a change in arrangements for revenue collection from TOs to the ESO. There is a lack of historical evidence or analysis including any justification from the ESO or Ofgem in relation to the cost associated with existing arrangements.
- There is an absence of a comprehensive Impact Assessment (IA) or consideration of alternative options for the proposed change in line with Ofgem Guidelines.
- There is no analysis on the impact on of the proposed change on customer bills for the existing or alternative proposals.
- The proposed change introduces a misallocation of risk and responsibility in the Electricity Transmission sector, particularly in relation to forecasting tariffs and cash flow volatility.
- There is no consideration of the impact on RIIO-T2 arrangements currently being developed or the risk to each individual company of in-year volatility or cost of debt allowances.
- There is no assessment of the impact of the proposals on other licence conditions including (but not limited to) the tax clawback mechanism, the Availability of Resources, Financeability Assessment (or indebtedness) and penalty interest rates.

- No reference has been made to additional Data Assurance obligations required in line with the Guidelines (DAG) and the importance of audit and assurance of tariff setting. All of these factors are likely to lead to higher costs to TOs and the ESO in the administration of TNUOS tariff setting and revenue collection processes.
- Our provisional analysis has made us question the benefit to the consumer as we would expect the additional costs of three Transmission Owners (TOs) managing cashflow risk to be higher than the costs of one ESO managing the same risk. In particular, with reference to the costs of carry or additional cash that must be held to manage this risk across each TO.

Please do not hesitate to get in touch with myself or Julie Scanlon (Julie.scanlon@sse.com) should you wish to discuss further.

Yours sincerely

Maz Alkirwi
Director of Finance

Appendix 1 - SSEN TNUoS Revenue Collection Risk Consultation Question Responses

Question 1: 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?

There are several aspects which should be considered and investigated further when assessing the reasonableness of allocating Transmission Use of system (TNUoS) cashflow risk to the onshore TOs. Firstly, a cost benefit analysis (CBA) or Impact Assessment (IA) in the context of the Electricity System operator (ESO), Transmission Owners (TOs) and consumers in relation to the proposed change. Such a CBA or IA, in line with Ofgem Guidance and industry best practice[1], would need to demonstrate sufficiently that "other options, at a lower cost to the industry"[2] are actually lower cost. There is a lack of evidence presented to show that this is indeed a lower cost to consumers. Some of the elements which should be considered include the following albeit this list is not an exhaustive list:

- An analysis of historic Correction Factors for TNUoS to demonstrate past trends and values for the ESO.
- Additional costs to TOs which include, but would not be limited to, additional resource for TOs as part of evaluating the ESO forecast and tariff setting process. This includes rights to access data, audit the process and calculations and ensure that each element has been fully considered prior to finalisation of ESO tariffs. This may even require a right of approval of tariffs by each TO given the risk would be shifted to the TOs instead of the ESO. Furthermore, the ESO would bear equivalent, if not higher, costs of audit and assurance as well as the requirement for enhanced engagement and visibility of tariffs.
- Consideration of arrangements should there be a financeability concern in relation to the TOs. If there is a financeability concern on the part of a TO which is then amplified by a negative allocation of cashflow risk from the ESO, how would this be dealt with?
- An evaluation of the impact on financeability for each TO over the period compared to the ESO.
- A worked example showing the effect on ESO and TO revenue and customer bills, based on past year's over/under recoveries.
- Consideration of TO financial viability assessments and expectations around how the TO would be able to forecast future allocation of any over/under recovery from the ESO.
- In Electricity Distribution, Distribution Network Operators (DNOs) have the responsibility and associated risk for setting tariffs. In this case, the allocation of risk is aligned to the licensee who has the responsibility. In contrast, the proposal set out in the consultation for TOs has the responsibility residing with the ESO but the risk sitting with the TOs. We do not believe the risk is being allocated correctly. The allocation of risk has not been considered by Ofgem in the consultation.
- Consideration of the treatment of penalty interest rates is required. There are penalty interest rates included within the licence for DNOs and TOs based on the over/under recovery of allowed revenue. However, in the case being consulted, the risk of TO over/under recovery would be influenced by the ESO but levied on the TO. Consideration of where the over/under recovery penalty interest should reside and how TOs should be compensated for any penalty interest levied during the period is required.

In relation to the allocation of the cashflow risk, the following points require to be considered:

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[1] Ofgem, Impact Assessment Guidance, https://www.ofgem.gov.uk/publications-and-updates/impact-assessment-guidance
[2] Ofgem, Consultation – TNUoS Revenue Collection Risk, December 2019

- The notice period from the ESO to the TO of any over/under recovery of revenue. TOs would have an uncertainty over the recovery of revenue, the forecasted recovery of revenue and the potential cashflow impact. This will have an impact on the costs of carry and borrowing costs which would need to be factored into the assessment of this proposal and configured into the RIIO-T2 settlement.
- The interaction between the notice period and the two year lag to ensure that TOs would be notified in time to build into the relevant year's tariffs.
- Considerations around excess gearing and tax clawbacks created due to the passing on of the cashflow risk. If the TO cannot accurately forecast gearing levels due to lack of clarity around over/under recovery being passed from the ESO, arrangements would be required to ensure that TOs are protected in terms of licence breaches influenced by such circumstances.
- The interaction with the Availability of Resources Licence Condition (B7) has not been considered in the consultation. This is an uncontrollable risk and therefore would need to be quantified and evaluated as part of that process.

Question 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 fundamentally do not agree with our revenues being affected by another Company's forecasting abilities. The proposal of transferring the cashflow risk does not involve any transfer of responsibility in the forecasting process, this responsibility would remain with the ESO. As TOs would in effect be exposed to inaccurate forecasting on the ESO's part, it would be required at a minimum that there are incentives in place to ensure that the ESO is encouraged to forecast with as much accuracy as possible. There should be penalties should the actual recovery fall out with a specified range of forecast revenue. Any over/under recovery out with the specified range would require explanation and justification. There should also be a penalty accelerator if this range is hit in two or more consecutive years.

An assessment should be made as to the cost to the consumer of incentivising the ESO to forecast as accurately as possible. Any incentive would be an additional cost to the consumer and so, it is important that expected incentive levels are built into the CBA or IA assessment which we have recommended to be performed in advance of a recommendation being made.

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

We are not convinced that moving the cashflow risk away from the ESO is appropriate as we have not seen any analysis to show that the movement of risk is beneficial to the consumer. The lack of an IA or any financial assessment is a concern and we do not believe these proposals have been considered adequately, which we have already communicated to Ofgem as part of the consultation process.

In terms of the modifications proposed, these appear appropriate should the movement of cashflow risk be proved to be appropriate. Our comments on the amendments are as follows:

- 3.4 (iii) and (iv) –this sets out that over/under recovery is passed onto the TOs in year. We are unclear as to the practicalities of this and in conversations with Ofgem it was communicated that the over/under recovery flow through would be subject to a two year lag. It appears the converse is true and we would be subject to in year revenue fluctuations as well as a two year lag on allowed revenue on the impact on TOs. This heightens the risk and volatility as well as the cost to consumers based on our assessment of the impact on SHE Transmission plc.

- 3.14 – invoicing arrangements are not covered in detail. The TO is required to invoice the ESO based on a monthly amount communicated from the ESO with reference to the amount the ESO has recovered. This would have to be done at least a month in arrears as the ESO will not know how much it will recover in the coming month. Such arrangements would therefore need to be agreed and defined, which would require changes to the rules and codes governing the interaction between the TOs and the ESO through the System Operator Transmission Owner Code (STC).

Question 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 do not believe any risk should be allocated to TOs unless it can be demonstrated through a CBA or IA that this is appropriate. The current lack of evidence means there is no justification for a material change in policy and licence conditions in this regard. We are unable to comment on whether the cost to the ESO is greater or less than the combined cost to the TOs alongside the increased cost of governance required in the ESO as part of a change in arrangements. When considering that such costs would now be across four companies rather than one, it seems highly unlikely that changes to the existing arrangement is justified.

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

We feel that a reallocation of risk will require a material change to the forecasting and tariff setting process for TOs and the ESO. We would propose that, at a minimum, TOs are involved in Working Groups with the ESO around forecasting approach in advance of the first year of charging to which the TOs would be exposed to the cashflow risk. This would include audit of information, provision of Data Assurance Guidance (DAG) obligations on the ESO and potential for approval by the TOs of the ESO's tariffs. Following this, annual reviews with the TOs of the fundamentals of the forecasting approach would be required to ensure that the approach is still valid, robust and accurate.

There would be substantial forecasting involvement required on the part of the TOs annually as well as regular audits of forecast assumptions and approach. As a TO, we foresee much higher resourcing costs if such a change were to go ahead. We would need to allocate additional resources to the monthly review of the ESO's invoicing schedule and to the forecasting assumptions used. Reviews would also involve checking items such as connection dates which feed into the invoice schedule. External audit of the forecasting approach would be required as would data assurance audits of the inputs to the forecasting process. Methodologies and process maps would need to be defined and agreed and updated on a regular basis.

A process would also need to be defined as to notification of the value of the recovery being passed onto the TOs, including timing and practical arrangements. This is in line with the DAG obligations placed on TOs as part of their tariff setting process whereby they hold the risk and the responsibility for setting tariffs. With such a material change, the DAG obligations are likely to be insufficient given the scale of the financial risk assessment in line with the DAG obligations

Consideration should also be made as to general price control arrangements for Electricity Transmission (ET) as a comparison to Electricity Distribution (ED). Currently, the DNOs perform their own forecasting exercises in order to charge their regulated revenue. The DNOs therefore have control over how they collect their revenue and are exposed to an over/under recovery. The fast money that DNOs are set is higher than in ET, which in part compensates for the financial risk associated with the exposure to over/under recovery. If the cashflow risk is reallocated to the TOs, the setting of fast money for ET in RIIO-2 should therefore be considered in line with the higher risk profile. Otherwise, the TOs are taking on higher risk with no mechanism in order to compensate for this risk.