Electricity transmission
owners, electricity suppliers,
electricity generators and all
other interested parties

Email: RIIO2@ofgem.gov.uk

Date: 09 July 2020

To interested parties,

Decision on re-allocation of TNUOS Revenue Collection Risk

Transmission Network Use of System (TNUoS) revenues are currently collected by the Electricity System Operator (ESO) and paid to the Transmission Owners (TOs), both onshore and offshore (OFTOs). Currently, the ESO pays the TOs based on ex-ante estimates, rather than on the basis of the TNUoS revenues it has collected, giving rise to a cashflow timing risk for the ESO.

In our December 2019 consultation[1], we sought views on our proposal to reallocate the cashflow timing risk of TNUoS revenue collection from the ESO to the onshore TOs.

This letter explains the relevant background to our proposal and sets out our decision to reallocate the cashflow risk. This decision reflects our assessment of the impacts of our proposal as summarised at Annex 1 and our consideration of consultation responses as set out in Annex 2.

Background

In April 2021, the first standalone price control for the ESO under the RIIO-2 framework is due to commence, and our Draft Determinations for the RIIO-2 price controls for the ESO and the TOs are published alongside this letter.[2] As part of developing a new, separate price control for the ESO we have been considering any changes (such as appropriate allocation of revenues, incentives and outputs between the ESO and TOs) that could reduce overall costs for consumers.

TNUoS charges recover the cost of installing and maintaining the transmission system in England, Wales, Scotland and offshore. The ESO recovers the revenue from TNUoS charges on behalf of: National Grid Electricity Transmission (NGET); Scottish Power Transmission (SPT); Scottish Hydro Electricity Transmission (SHET); OFTOs, and other network schemes.

[1] https://www.ofgem.gov.uk/publications-and-updates/transmission-network-use-system-tnuos-cashflow-timing-consultation
[2] https://www.ofgem.gov.uk/publications-and-updates/riio-2-draft-determinations-transmission-gas-distribution-and-electricity-system-operator

The TOs inform the ESO of their allowed revenues annually. The ESO then sets TNUoS charges to reflect this and these charges are paid to the ESO by suppliers and generators. There are various reasons why a difference may arise between the collected TNUoS revenue and what the ESO has paid to TOs and other parties. For example, the ESO's forecast of volumes may differ from outturn volumes.

Currently, the ESO pays the revenue that the TOs are allowed, as specified in the TOs' price controls, rather the actual TNUoS revenues the ESO has collected. Therefore, currently the ESO is exposed to the cash difference between collected and allowed revenues, until recovery is made via the so-called 'K' correction term.[3]

Previously the ESO was part of NGET and the magnitude of the variance was modest compared to the size of NGET's Regulatory Asset Value (RAV) (over £13bn) and borrowings. However, since the ESO has separated from NGET and became a standalone legal entity, the size of the variance is less modest relative to the ESO's RAV (£211m in nominal terms at the end of 2019/20) and borrowings.

December 2019 consultation proposal[4]

In our December 2019 consultation we set out our proposal and explained why we were considering reallocating the TNUoS collection cashflow timing risk from the ESO to the onshore TOs. We did not propose to change how the ESO allocates TNUoS revenue to OFTOs or other parties.

We did not propose to move OFTO-related cashflow timing risk because these are a much smaller proportion of overall revenues (approximately 11%) and therefore a smaller proportion of the difference between allowed and collected revenues. In addition, doing so would run contrary to the assumptions on which OFTO bidders bid during the competitive bid stage and their project-financed structures are based; namely, that OFTOs were not exposed to revenue collection timing risk. We also expect Competitively Appointed Transmission Operators (CATOs) to exist in the future. We confirmed we would consider the approach for CATOs as and when this policy is further developed.

We proposed that any decisions made to change the allocation of the TNUoS cashflow timing risk in time for the start of RIIO-2 would be taken into account in our price control determinations for the ESO and onshore TOs.[5]

Responses to consultation

We received six responses to the consultation from stakeholders including the ESO, the three onshore TOs, and two other interested parties (Centrica and ESB), which we publish alongside this letter. In summary, four responses were broadly supportive of the proposed re-allocation of TNUoS cashflow risk to the onshore TOs and two were against. In Annex 2, we summarise the issues raised in consultation responses and provide our views on those issues.

Funding arrangements and assessing impacts

Funding arrangements

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[3] Special Licence Condition 3A of the ESO's transmission licence sets out the level of allowed revenue that may be recovered by the ESO through Transmission Network Use of System Charges - the 'K' correction term therein reflects the difference between allowed and collected revenues
[4] https://www.ofgem.gov.uk/publications-and-updates/transmission-network-use-system-tnuos-cashflow-timing-consultation
[5] https://www.ofgem.gov.uk/publications-and-updates/riio-2-draft-determinations-transmission-gas-distribution-and-electricity-system-operator

Several stakeholders sought clarification on funding for the new arrangements. This decision on moving TNUoS revenue collection risk reflects our view on what is most efficient for the industry overall and is therefore not dependent on the level of remuneration for individual industry participants. As part of our RIIO-2 Draft Determinations, we welcome views from stakeholders on risk benchmarking and associated remuneration (see question FQ6a in the Finance Annex). We consider that views on risk and remuneration, including any cashflow risk issues, are more appropriately captured in that forum. We will take any such views into account in our RIIO-2 Final Determinations.

Assessing the impacts

Stakeholders sought further information on the impact of our proposal. We considered our duty as set out in section 5A of the Utilities Act 2000 with regards to carrying out a statutory impact assessment.[6] We do not consider this decision involves a major change to the Authority's activities, and we do not consider that it will have significant impacts on industry participants, the general public or on the environment. For these reasons, we have considered the impacts in a proportionate way, in line with our impact assessment guidance.[7] A summary of our considerations are set out at Annex 1, alongside our consideration of stakeholder responses at Annex 2. Although we consider the monetary benefits of our proposal are difficult to quantify, in our view, the direct monetary impacts are relatively small. We note that the Better Regulation Framework indicates that impacts less than £5m are treated proportionately, in terms of impact assessment.[8]

Decision and rationale

Having considered stakeholder views, we have decided to reallocate the TNUoS collection cashflow timing risk from the ESO to the onshore TOs. Moreover, we have reconsidered the detail of the consultation proposal and have decided that implementation of this decision should be as follows:

- The K term should be maintained in the ESO licence. This is a relatively small change from our consultation position and reflects our view that retention of the K term will offer benefits in terms of future flexibility.
- We will remove the penal interest rates in the calculation of the K correction term from NGET, SHET and SPT's licences. This reflects our consideration of TO responses to the consultation. We agree with TOs that a penal rate does not seem appropriate because TOs are not directly responsible for setting TNUoS tariffs.[9]
- The ESO will allocate revenue between all onshore TOs, consistent with the principle that the ESO will only pay invoiced TNUoS revenue, net of payments due to OFTOs and other parties. Our rationale reflects feedback we received from stakeholders that a pay as invoiced approach is simpler to implement. Whilst we do not believe this is a material issue we have decided to implement the change on that basis.

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[6] https://www.legislation.gov.uk/ukpga/2000/27/section/5A
[7] https://www.ofgem.gov.uk/system/files/docs/2020/05/impact_assessment_guidance_1.pdf#page=9
[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/872342/better-regulation-guidance.pdf#page=8
[9] Please see the draft determinations finance annex for further consideration of the rates of interest that apply to cash flow timing issues and to the K term. We seek views on this as part of RIIO-2 draft determinations (see finance questions FQ31, FQ32 and FQ33).

We explained our view in the consultation that this change would have a number of benefits, including overall efficiency of the industry arrangements and for incentives.[10] We explained that the onshore TOs’ larger RAVs, and direct interest in their allowed and collected revenues, make them, in our view, a more natural, and more economical, owner of this cashflow timing risk exposure.

The difference between allowed and collected revenues can be material in relation to the size of the ESO – this means that the finance cost, if allocated to the ESO, would, in our view, be less efficient because financiers (both debt and equity) in the ESO would require a larger allowance than financiers (both debt and equity) in the onshore TOs.

Our view on these benefits has not changed.

This decision will be effective from 1 April 2021, and we will include the licence modifications associated with this decision alongside the wider RIIO-2 statutory consultation towards the end of this year, which will allow stakeholders to submit any further implementation views, at that time.

Yours sincerely,

Steve McMahon
Deputy Director, Systems and Networks
Signed on behalf of the Authority and authorised for that purpose

[10] See the consultation here: https://www.ofgem.gov.uk/system/files/docs/2019/12/tnuos_cashflow_timing_consultation_002.pdf#page=12

Annex 1 – Assessment of impacts of moving TNUoS Revenue Collection Risk from the ESO to the onshore TOs

Benefit to the ESO of a re-allocation of TNUoS Cashflow Risk

The ESO will benefit from this change because it will reduce a material part of the liquidity risk it would otherwise hold. In March 2019, a credit rating performed by Moody's[11] noted that the ESO's rating was constrained by exposure to such revenue collection activities. The rating provided by Moody's (which was "investment grade") was reliant on Moody's assigning a high likelihood of parental support should it become necessary to maintain ESO credit quality.

Prior to legal separation, the magnitude of the cashflow variance was modest compared to the size of NGET's Regulatory Asset Value (RAV) (over £13bn) and NGET managed TNUoS cashflow variances using the wider working capital needs of NGET's business. In contrast, the size of the variance is less modest relative to the ESO's RAV (£211m in nominal terms at the end of 2019/20[12]) and borrowings.

Cost to the TOs of re-allocation of TNUoS Cashflow Risk

Our decision will bring onshore TOs into line with other network companies, including those in electricity and gas distribution, electricity transmission prior to NGET separation,[13] as well as the water industry, who have the equivalent of a K correction term such that in the short term, each company is exposed to some small uncertainty on the exact quantum of collected revenues.

Administrative costs associated with TNUoS Revenue Collection Risk Re-allocation

We have collected administrative costs for National Grid when it administered TNUoS revenues and have also considered the ESO's administrative costs since 2019. In light of this information, we do not consider that these changes to the TNUoS arrangements will lead to significant additional administrative costs to the TOs or the ESO.

Incentive Scheme Costs associated with TNUoS Revenue Collection Risk Re-allocation

It is our view that the obligations and incentives on the ESO to produce accurate forecast and tariff calculations can be maintained or improved through other options, at a lower cost to industry than would be the situation if the ESO continued to carry this cashflow risk. This can be achieved through licence obligations and the ESO's incentives scheme. We refer stakeholders to our RIIO-2 Draft Determinations on the ESO's price control to submit any further views on this point.

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[11] https://www.moodys.com/research/Moodys-assigns-Baa1-rating-to-National-Grid-Electricity-System-Operator--PR_396553

[12] RIIO-ET1 Financial Model following the Annual Iteration Process 2019: https://www.ofgem.gov.uk/publications-and-updates/riio-et1-financial-model-following-annual-iteration-process-2019

[13] Prior to BETTA and the introduction of GB wide charging in 2005, SHET and SPT each carried the equivalent to TNUoS under-recovery risk.

Annex 2 – Summary of responses to our December 2019 Consultation and Ofgem's views

Respondents' views and Ofgem's responses

We received six responses to the consultation from stakeholders including the ESO, the three onshore TOs, and two other interested parties (Centrica and ESB).

In summary, the ESO, NGET, Centrica and ESB were broadly supportive of the proposed re-allocation of cashflow risk to the onshore TOs, but Scottish and Southern Energy Networks (SSEN) and SPT raised concerns about onshore TOs taking on a risk over which they have no control, and that the proposal represented a significant new consideration at this stage in the development of the TOs' RIIO-2 funding model. Several respondents requested further cost benefit analysis.

Below we summarise the key issues from the responses to our consultation, covering both general issues raised and the responses to the specific questions asked, and our response.

General issues raised

Our proposal represents a significant change and risk requiring additional funding

Respondents' views

SPT and SSEN considered that the cashflow risk presented an additional, and unquantified, risk for the TOs which has not been accounted for in their finalised RIIO-T2 Business Plans.

SPT considered it inappropriate to introduce a new risk into our regulatory framework with no opportunity for them to mitigate this as part of their Business Plan submission. They considered that this new risk would also need to be reflected through the cost of equity assessment for RIIO-T2.

SPT also considered that there would be additional costs on the TOs in the management of new treasury policies, which would require expensive facilities to manage this new higher cashflow risk environment, and that the full costs of this exposure must be able to be recovered by the TOs. SPT argued that the consultation should have contained more details on how Ofgem's price control determinations for RIIO-T2 would take into account the change of cashflow allocation risk.

SPT noted that in other sectors, such as electricity distribution, Distribution Network Operators (DNOs) have the responsibility and associated risk for setting tariffs. In contrast, Ofgem's current proposal would have the tariff-setting responsibility residing with the ESO but the revenue risk sitting with the TOs, and SPT believe the risk is not being allocated correctly.

NGET recommend an allowance to TOs to cover their increased costs, but overall considered that costs across TOs in aggregate should be cheaper than the costs faced by the ESO until synergies within TOs are exhausted.

The ESO noted that taking on the TNUoS cashflow risk could result in additional costs for the TOs.

Our view

We agree with NGET that costs across the TOs in aggregate should be cheaper than costs faced by the ESO. However, historically we have not provided any explicit funding to NGET when it carried the TNUoS cashflow risk, nor did we reduce the funding for SHET and SPT when they were exposed to proportionally less TNUoS cashflow risk.

We note that the TOs have a role in tariff-setting – we therefore believe they can influence revenues collected and partially control associated risks. We also note our RIIO-2 proposals provide TOs with a greater ability to forecast their price control revenues. As part of our RIIO-2 Draft Determinations, we are seeking views from stakeholders on risk benchmarking and associated remuneration (see, for example, question FQ6a in the Finance Annex).

K Correction Rate of Interest

Respondents' views

Several respondents argued that the treatment of penalty interest rates needs to be reviewed.

There are penalty interest rates included within the licence for DNOs and TOs based on the degree of over/under recovery of allowed revenue. Stakeholders therefore highlighted that the risk of TO over/under recovery would be influenced by the ESO but levied on the TO.

Onshore TOs asked for a 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 required.

Our view

We note that the TOs will be exposed to revenue collection risk whilst not being directly responsible for setting tariffs. Our decision therefore is to remove the penal interest rate, and apply the same flat rate whatever the extent of under/over recovery.[14]

Requirement for Cost Benefit Analysis / Impact Assessment

Respondents' views

Both SSEN and SPT questioned the benefit to consumers of our proposal as they would expect the additional costs of three TOs managing cashflow risk to be higher than the costs of one ESO managing the same risk. They considered the costs of carry or additional cash that must be held to manage this risk across each TO to be higher for the TOs in aggregate than for the ESO.

NGET, SPT and SSEN considered that pursuant to good practice and to Ofgem's own RIIO principles risk should lie with the party or parties best able to manage that risk, and that wherever the risk is managed, there should be adequate recompense for the party.

The ESO 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.

Although the ESO did not comment on the size of the possible costs to the TOs, they 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.

[14] There is further discussion of K Correction rate of interest in the Finance Draft Determinations document, which can be found at https://www.ofgem.gov.uk/regulating-energy-networks/price-control-announcements

Our view

We considered our duty as set out in section 5A of the Utilities Act 2000 with regards to carrying out a statutory impact assessment.[15] We do not consider this decision involves a major change to the Authority's activities and we do not consider that it will have significant impacts on industry participants, the general public or on the environment. For these reasons, we have considered the impacts in a proportionate way, in line with our impact assessment guidance.[16]

Responses to consultation 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?

Working Capital Facility (WCF)[17] Funding

Respondents' views

The ESO agreed that the transfer of TNUoS risk under this proposal could significantly reduce the size of facility required, but argued that a facility would still need to be funded through the agreed RIIO-2 funding framework in order to manage the remaining cash flow risks.

Our view

Our proposals as regards the costs of the WCF are set out in the ESO Draft Determination.

Increased level of scrutiny of TNUoS tariff setting

Respondents' views

SPT considered that the notice period from the ESO to the TO of any over/under recovery of revenue would 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.

Our view

We do not consider the notice period to be a material risk factor or an issue that influences the most efficient overall industry arrangements for TNUoS risk allocation. In terms of costs, TOs can outline their considered risk position in response to RIIO-2 Draft Determinations.

Tax Clawback

Respondents' views

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

[15] https://www.legislation.gov.uk/ukpga/2000/27/section/5A
[16] https://www.ofgem.gov.uk/system/files/docs/2020/05/impact_assessment_guidance_1.pdf#page=9
[17] Working Capital Facility means a committed or uncommitted revolving credit facility entered into by the Borrower or a Subsidiary to obtain working capital financing in the ordinary course of business

to ensure that TOs are protected in terms of licence breaches influenced by such circumstances.

Our view

We consider the situation for TOs to be no different to other sectors who are also subject to the tax clawback mechanism, without any adjustment for the extent of under-recovery. We discuss our proposals on tax clawback in the Draft Determinations Finance Annex.

Availability of Resources Licence Condition (Standard licence condition B7)

Respondents' views

SPT and SSEN were of the opinion that the interaction with the Availability of Resources Licence Condition (B7) had not been considered in the consultation. They argue that this is an uncontrollable risk and therefore would need to be quantified and evaluated as part of that process. SPT were also concerned how any financeability concerns, which are then amplified by a negative allocation of cashflow risk from the ESO, would be dealt with.

Our view

TOs have a role in tariff setting, and under our RIIO-2 proposals have a greater ability to forecast revenues. The risk is therefore not uncontrollable, in our view.

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?

Respondents' views

There was a range of views on whether the ESO should be incentivised to produce an accurate TNUoS forecast, and whether the current arrangements to provide scrutiny of TNUoS tariff setting are sufficient.

SPT considered that the strongest incentive for the ESO is to retain exposure to the cost and risk of TNUoS forecast error. SPT is strongly of the view that establishing a WCF would be a sensible way to manage this, and do not consider that reliance on licence obligations and incentives will fully achieve what retaining responsibility and exposure to actual costs would instead drive.

As TOs would in effect be exposed to inaccurate forecasting on the ESO's part, SPT considered that at a minimum that there should be incentives in place to ensure that the ESO is encouraged to forecast with as much accuracy as possible. SPT considered that there should be penalties should the actual recovery fall outwith a specified range of forecast revenue, and that any over/under recovery out with the specified range would require explanation and justification.

Centrica agreed that licence obligations and the evaluative incentive scheme are appropriate to encourage the ESO to produce accurate forecasts and tariff calculations, and that these mechanisms may be revised if necessary. They also suggested it may be appropriate to place obligations on the ESO and TOs via the System Operator - Transmission Owner Code (STC) to collaborate to produce accurate forecasts and tariff calculations.

The ESO acknowledged 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, they considered 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 values outside a certain threshold (Part F of Special Licence Condition 3A of the ESO's licence) 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 (Parts G and H of Special Licence Condition 3A of the ESO's licence).

The ESO noted that the TNUoS tariff calculation is defined in the Connection Use of System Code (CUSC), 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.

NGET agreed that, in principle, ESO incentives to accurately forecast the charge base and calculate the tariffs could be established. They suggested the ESO incentives should be symmetrical incentives and provide a stronger signal to discourage persistent over-recovery or under-recovery over a period of time.

Our view

The ESO already has a licence obligation to provide accurate forecasts[18]. Moreover, all ESO activities will be considered as part of our evaluation of the ESO's performance, which is linked directly to the ESO's financial incentives. In our RIIO-2 Draft Determinations, we have also proposed that the ESO's demand forecasting performance should be reported explicitly by the ESO as part of its incentives framework[19]. Industry has an obligation to keep the CUSC and STC under review, and the existing codes allow the ESO and TOs to propose modifications to the existing arrangements.

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

Respondents' views

The ESO agreed that licence changes and code modifications are the most appropriate way to move the cashflow risk, but considered the proposed implementation date of 1st April 2021 to be challenging, but has since revised this view.

The ESO noted that an error in the suggested amendment to Standard Licence Condition B12,[20] which stated is that the amount payable to onshore TOs should be pro-rata to Total Transmission Charges, which is inconsistent with suggested STC drafting in the consultation document which says that revenue should be shared "proportionate to … total onshore revenue".

SPT argued that as the ESO's RIIO-2 incentives package hasn't yet been established, they cannot say whether the licence and code modifications proposed are the most appropriate way of transferring the cashflow risk to the TOs or not.

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[18] See standard licence condition C16 here: https://epr.ofgem.gov.uk//Content/Documents/Electricity%20transmission%20full%20set%20of%20consolidated%20standard%20licence%20conditions%20-%20Current%20Version.pdf#page=265

[19] Details of our proposals for the ESO's output incentive scheme can be found in the ESO draft determination document.

[20] B12 is a standard licence condition for transmission licensees. It outlines the code between the system operator and the transmission owner (the "STC"). https://epr.ofgem.gov.uk//Content/Documents/Electricity%20transmission%20full%20set%20of%20consolidated%20standard%20licence%20conditions%20-%20Current%20Version.pdf#page=90. We proposed modifications to this condition in the consultation: https://www.ofgem.gov.uk/system/files/docs/2019/12/tnuos_cashflow_timing_consultation_002.pdf#page=17

Our view

We agree there was drafting error in our proposed revision to Standard Licence Condition B12. The proposed licence drafting will be corrected and consulted on later this year as part of our planned RIIO-2 licence changes. We note that the ESO and TOs will be responsible for progressing the required changes to the STC resulting from the change to Standard Licence Condition B12.

<u>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?</u>

Respondents' views

NGET sees 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.

The ESO noted 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. Instead, they note that OFTO related cashflow timing risk would be borne by the onshore TOs. In addition, they noted that Ofgem currently considers that CATOs should be treated in the same way as OFTOs.

The ESO acknowledged 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, as there is a possibility that any CATOs that do come to exist could become significant in the future, the ESO support Ofgem's consideration of the approach for CATOs as and when the CATO policy further develops.

Our view

No compelling evidence was provided through the consultation that would change our original position. Ofgem policy therefore remains unchanged in that the TNUoS cashflow risk will be transferred to the existing onshore TOs only, and that any allocation to CATOs will be considered as and when the CATO policy develops further.

Respondents' views

SPT considers the ESO to be part of a large organisation, the National Grid Group, which has historically been able to bear the cashflow risk effectively. SPT sees no reason not to allow the ESO's parent organisation to share this risk on an ongoing basis if a WCF cannot be established.

They argue that site-specific charges, which form part of the TNUoS revenue calculation, need further consideration as they are not subject to volume demand risk and therefore should not come under this new proposal. SPT feels they should be excluded from this proposal and TOs should receive the revenue for these charges per the process that is in place today.

Our view

We propose RIIO-2 price controls on a notional basis and this decision reflects this, for both the ESO and the TOs. We are not proposing to change how TOs receive revenue associated with site-specific charges. Site-specific charges are not a material part of TNUoS revenues and therefore it would, in our view, be unnecessarily complex and disproportionate to treat these revenues in a distinct way.

Respondents' views

SSEN does not believe any risk should be allocated to TOs unless it can be demonstrated through a CBA or IA that this is appropriate. They were 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, SSEN considered it highly unlikely that changes to the existing arrangement is justified.

NGET supports 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.

Our view

We outline our view on Impact Assessment above. SSEN's response did not substantiate its view on costs so we had no firm basis upon which to agree with its view. Our assessment in Annex 1 of impacts does not indicate issues that change our view of the overall benefits for electricity consumers.

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

Revenues retained by ESO

Respondents' views

The ESO's interpretation of the proposed changes is that all revenues collected will be passed over to the onshore TOs on a pro-rata basis. However, they suggest that the consultation is not clear on this point as the amounts relevant to those onshore TOs do not represent the entirety of TNUoS charges. Consequently, they argue that it is 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 (ITC) payments. As such, the ESO argues that it 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.

Our view

It is our intent that the ESO will be paid for its expenses, such as licence fees, and that only the net invoiced money will be distributed to the on-shore TOs. In our ESO RIIO-2 Draft Determinations, we state that we will consider whether other pass-through costs, such as licence fees and ITC, should be recovered via TNUoS or BSUoS as part of the licence drafting consultation later this year.

Transfer of TO final sums risk

Respondents' views

The ESO provided views on construction agreements. 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, the ESO believes that it would need to retain a K mechanism if this risk was not held by the TOs.

The ESO noted that 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). In its view, a further change would therefore be needed to achieve the aim of this consultation to remove K completely from the ESO licence.

Our view

We will retain the K term for the ESO, and will reflect this in our licence modifications, which will be further consulted on in due course.

Bad Debt

Respondents' views

SPT agreed with Ofgem that the risk of bad debt must be retained by the ESO who remains responsible for managing this, and that exposure to this risk should not be passed onto the TOs.

NGET agreed 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 consumers' interests.

The ESO supports a mechanism based on invoiced amounts, as proposed in the consultation, rather than cash received, and for any bad debt risk to remain with the ESO. The ESO believes 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.

Our view

The Draft Determination Finance Annex outlines Ofgem's proposals on how bad debt will be recovered. We welcome further views from stakeholders as part of the RIIO-2 consultation process.

Management of TNUoS revenue-setting process

Respondents' views

In SSEN's view, there would be additional costs to TOs, including additional resource for TOs as part of evaluating the ESO forecast and tariff setting process. They 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.

SPT's view was that if Ofgem chooses to proceed with this proposal, it would expect TOs to have the opportunity to review the ESO's modelling, methodology and assumptions for effectiveness, given that the TOs will ultimately bear the risk of the ESO's management of TNUoS revenue setting and collection.

SPT would also expect the ESO's processes to fall under the official Data Assurance Guidance (DAG) process, given the implications of the ESO's execution of these responsibilities on the TOs. The ESO's processes must be fully transparent and published, given that TOs have no control over these processes. This is a similar arrangement to the process which DNOs follow in setting and collecting charges for use of the distribution system. To protect consumers, SPT are of the view that the range of forecasting error should also be capped and the ESO, who are responsible for this, must be exposed to costs above the cap.

SSEN considers that a reallocation of risk will require a material change to the forecasting and tariff setting process for TOs and the ESO. SSEN proposed 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 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.

SSEN considered that 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.

SSEN noted that no reference had 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.

Currently the ESO can adjust subsequent TNUoS tariffs to reflect differences between collected and allowed revenues through its Special Licence Condition 3A. If the onshore TOs have to bear this additional risk, SPT consider it essential that they have a remedy or legal right of recourse if there is a payment shortfall. Ofgem will need to explain how this would work in practice.

Our view

We consider the TNUoS forecasting process is transparent, but we encourage the ESO and TOs to work together to improve further, in light of the issues raised. We do not consider a cap on under-recovery cashflows to be necessary but we will keep it under review.

We are removing the penal rate of interest in the K correction term. We would require the ESO to have in place appropriate data assurance processes as per Standard Licence Condition B23. We will consider further whether the existing DAG obligations as set in Standard Licence Condition B23 (Data assurance requirements) continue to be sufficient as part of the RIIO-2 licence drafting process later this year. We do not believe there are significant costs in moving to a pay-as-invoiced scheme.

Additional Resources

Respondents' views

SSEN believe that 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, SSEN foresees much higher resourcing costs if such a change were to go ahead, and they would need to allocate additional resources to the monthly review of the ESO's invoicing schedule and to the forecasting assumptions used. SSEN believe reviews would also involve checking items such as connection dates which feed into the invoice schedule, and that 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.

SSEN were of the view that 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. SSEN claimed that if the cashflow risk is reallocated to the TOs, the setting of fast money for ET in RIIO-2 should therefore be reviewed in line with the higher risk profile, as otherwise the TOs are taking on higher risk with no mechanism in order to compensate for this risk.

Our view

As noted above, our decision on TNUoS collection risk re-allocation reflects our view on what is most efficient for the industry overall and, in our view, is not dependent on the level of remuneration for individual industry participants. As part of our RIIO-2 Draft Determinations, we are seeking views from stakeholders on risk benchmarking and associated remuneration (see, for example, question FQ6a in the Finance Annex). We consider that views on risk and remuneration, including any cashflow risk issues, are better captured in that forum.

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

Respondents' views

Respondents noted that 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. The ESO would urge Ofgem to consider the outcomes of these modifications in light of these proposals.

Our view

We have not seen evidence that the new structure of the demand residual charge will materially impact the over- or under-recovery of TNUoS revenue. The ESO and TOs should investigate this further as the new charge design is finalised. Any issues identified that suggest the new charge would lead to an increase in the difference between recovered and allowed revenue should be raised with Ofgem.

BSUoS revenue collection

Respondents' views

Several stakeholders supported Ofgem's proposal to engage with the Balancing Use of System Charges (BSUoS) taskforce[21] to ensure the conclusions of this consultation consider the possibility of the introduction of another K factor for BSUoS charges.

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[21] Please see:
https://www.ofgem.gov.uk/system/files/docs/2019/02/decision_to_launch_a_balancing_services_charges_taskforce.pdf

Our view

In 2019, we asked the ESO to launch a second Task Force to consider the appropriate future arrangements for BSUoS. It is possible that future changes to BSUoS arrangements could also have implications for the cashflow risk faced by the ESO. We will evaluate the Task Force recommendations to ensure they have taken into account the potential costs and impact on consumers of any changes to the ESO's risk profile and funding requirements, considering any interactions with the RIIO-2 price controls.