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Direct Dial: 0207 901 7050

The National Grid Electricity Transmission plc,
CUSC Signatories and Other Interested Parties

11 October 2006

Our Ref: GB-ECM-05

Dear Colleague,

**Decision in relation to use of system charging methodology modification
proposal GB ECM-05: Manifest data errors in the calculation of TNUoS**

The Gas and Electricity Markets Authority (the "Authority")¹ has considered the issues raised in the Conclusions Report² in respect of the proposed use of system charging methodology modification proposal ("GB ECM-05"): Manifest data errors in the calculation of TNUoS tariffs (the "Proposal").

National Grid Electricity Transmission plc ("NGET") submitted the Conclusions Report to the Authority on 22 September 2006 and recommended to the Authority that the modification proposals be approved.

In reaching our decision we have considered whether this modification proposal better achieves NGET's relevant objectives as set out in Standard Condition C5 of the electricity transmission licence.³ In addition, we have considered whether this modification proposal is consistent with our principle objective and general duties.⁴

¹ Ofgem is the office of the Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this letter.

² Conclusions Report, GB ECM-05, Modification Proposal to the Transmission Network Use of System Charging Methodology to cater for manifest errors in the calculation of TNUoS charges, dated 22 September 2006.

³ The Relevant Objectives of the use of system charging methodology are:

- (a) to facilitate 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;
- (b) to result in charges which reflect, as far as is reasonably practicable, the costs incurred by the licensee in its transmission business; and that
- (c) 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 the licensee's transmission business.

⁴ As set out in sections 3a-3c of the Electricity Act 1989.



Following consideration of the above factors the Authority has decided **not to veto** the proposed GB ECM-05. The modification will therefore be implemented on 20 October 2006 as set out in the Conclusions Report.

This letter sets out the background to and explains the Proposal and sets out our reasons for this decision.

Background to the Modification Proposal

In April 2005 the British Electricity Trading and Transmission Arrangements ("BETTA") came into effect. As part of BETTA, the DC Loadflow ("DCLF") Investment Cost Related Pricing ("ICRP") based transport model used for calculating locational TNUoS charges in England & Wales was extended to incorporate Scottish network data.

Following the publication of the 2005/06 TNUoS tariffs it was highlighted that erroneous network data had been used for two circuits between Dalmally and Cruachan in SP Transmission Ltd's transmission area. The error involved the underestimation of the length of the circuit comprising overhead line ("OHL") and the overestimation of the length of the circuit comprising cable. Given cable is treated as more expensive than OHL then the impact of this error was to apply significantly higher marginal km figure had been used for the node at the end of the circuit with the result that Cruachan power station was allocated to a TNUoS charging zone of its own and its £/kW TNUoS generation tariff overstated.

The existing TNUoS charging methodology does not have a mechanism to reconcile such a "manifest error" in TNUoS charges. As a result, the existing arrangements could result in TNUoS tariffs which are not cost-reflective.

The Modification Proposal

NGET propose to modify Chapters 4 and 5 of the Statement of Use of System Charging Methodology to include a mechanism by which a manifest error which results in a "material discrepancy" in a User's TNUoS charges can be reconciled.

Under the proposal a manifest error is defined as one of the following:

1. an error in the transfer of relevant data between the transmission licensees or Distribution Network Operators
2. an error in the population of the transport model with relevant data
3. an error in the function of the transport model; and
4. an error in the population of the inputs, or function of the tariff model.

The proposal sets out that the materiality test be:

1. an error in a user's TNUoS tariff of +/-£0.50/kW or greater; or

2. an error in a user's TNUoS tariff which results in an error in the annual TNUoS charge of +/-£250,000 or greater.

Under the proposals a manifest error shall only be reconciled if it has been identified within the charging year for which the error has an effect. Where errors identified are outside of this period then they will not be eligible for reconciliation retrospectively.

The basis for reconciliation will be the recalculation of TNUoS tariffs in line with the existing methodology which prevails for demand and generation Users. Where reconciliation on that basis is not practicable within this framework (for example in the case of Cruachan where charges cannot be reconciled in line with the timescales involved) then a post-year reconciliation will be undertaken in the form of a one-off payment.

Finally, NGET propose that all variances in allowed revenue resulting from the reconciliation of TNUoS tariffs as a result of a manifest error should be included within the calculation of any under/over recovery of income for that year. This approach would involve TNUoS tariffs being reconciled post-year using the existing reconciliation process for TNUoS tariffs.

Respondents' views

NGET issued a pre-consultation document in June 2006 to which three responses were received. A further consultation paper was issued in August 2006 inviting responses from Users and other interested parties by 8 September 2006.

NGET received six responses to the consultation which were broadly supportive of the proposed modification. The respondents' views are summarised and contained in the Conclusion Report in respect of GB ECM-05⁵.

Changes to the proposal in light of respondents' views

In light of respondents comments NGET proposed two minor changes to the original proposal.

1. The definition of manifest errors was adjusted to facilitate the reconciliation of a User's TNUoS charges in the event of an error in the demand forecast that has a material impact on a user. The revised text now includes reference to errors in the transfer of relevant data not just between the transmission licensees but also between Distribution Network Operators.

⁵ www.nationalgrid.com/NR/rdonlyres/A5259A99-9CC5-4B6C-B175-3690693A8936/10840/GBECM05ConclusionsReportFINAL.pdf

2. The revised text reflects that, in the event of multiple manifest errors in any TNUoS charging year, it is the aggregate effect of the errors which will be considered rather than the effect of each individual manifest error in isolation.

Ofgem's view

The Authority must first assess the proposal against the relevant objectives specified in NGET's licence. If the proposal better achieves the relevant objectives then the Authority must then consider whether that proposal is consistent with its principal objective and general duties.

One specific issue that Ofgem picked up from respondents comments was in relation to the criteria for determining the materiality of an error. Ofgem note that one party argued for a smaller absolute threshold of +/-£0.25kW and a de minimus value of +/-£100,000 as being more appropriate on the grounds that a +/-£0.50kW level would represent an error of £1m for a 2GW generator. However, Ofgem recognises that this was based on a misunderstanding of the materiality criteria and that actually any error above £250,000 would be eligible for reconciliation.

NGET consulted on the materiality issue and in Ofgem's view presented a robust justification for the criteria based on determining an acceptable tolerance for a discrepancy in the measurement of current circuit data. Further, Ofgem notes that the other respondents who commented on materiality agreed with NGET's proposed definition. Two of the reasons cited were that no classes of users were discriminated against and that the proposal is proportionate to the nature of errors likely to occur.

Relevant objectives

SLC C5 5(b) – cost-reflectivity

The Proposal ensures that charges reflect the costs incurred by the transmission licensee in their transmission business by providing a mechanism for correcting for manifest errors in the calculation of charges.

Further, by providing for a within charging year reconciliation the Proposal will also ensure that transmission charges are more cost-reflective in any given year.

SLC C5 5(c) – reflect developments in the transmission system

The introduction of BETTA necessitated for the first time the three TOs to provide a network dataset to NGET for the purpose of developing the GB DCLF transport model. It was mistakes in the datasets used that result in the error in the charges paid for Cruachan. The Proposal is a direct response to the issues highlighted by that error.

Further, given the timescales NGET has proposed a separate solution to address the over-recovery from Cruachan from that proposed for ongoing manifest errors. Again, the Proposal can therefore be considered to take proper account of developments in transmission licensees' transmission businesses.

SLC C5 5(a) – facilitate effective competition

Robust cost-reflective charging arrangements play an important role in promoting efficiency and facilitating competition. Therefore, to the extent that NGET's proposed treatment of manifest errors improves cost-reflectivity then it can be considered to have a positive impact on the facilitation of effective competition.

Further, under NGET's proposal the definition of a manifest error will be set out in the charging methodology. This, combined with the fact that the data used is from the Seven Year Statement and thus publicly available, provides for greater transparency which in turn facilitates competition.

Finally, by limiting the period of reconciliation of manifest errors to one year, it removes any potential uncertainty that may arise for users from addressing manifest errors over a longer time period. In particular, Ofgem agrees with the views expressed by one respondent that this approach will result in the minimum disruption to year on year charges.

Overall assessment against the relevant objectives

NGET's proposal better achieves the relevant objectives of cost reflectivity and reflecting developments in the transmission system. To the extent to which cost reflective charges benefit competition it also marginally better achieves the relevant objective in relation to promoting competition.

Therefore, overall, Ofgem considers the proposal better facilitates achievement of the relevant objectives.

The Authority's principal objective and general duties

The Authority's principal objective is to protect the interests of consumers, wherever appropriate by promoting effective competition.

As noted above, Ofgem considers that the Proposal, if implemented, will have a positive impact on both cost-reflectivity and competition. By extension Ofgem considers the Proposal will therefore be in the interests of consumers.

In particular, as noted above by identifying that only manifest errors that have been identified within the charging year will eligible for reconciliation, the Proposal removed

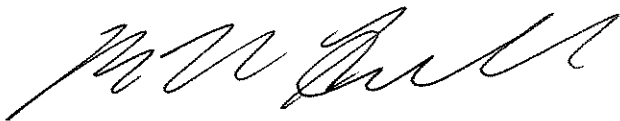
the subsequent uncertainty associated with out of year reconciliation. The removal of such uncertainty is also in the interests of consumers.

The Authority's Decision

The Authority has therefore decided **not to veto** the proposed GB ECM-05.

Please contact me on the above number if you have any queries in relation to the issues raised in this letter.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Robert Hull', written in a cursive style.

Robert Hull
Director, Transmission

Signed on behalf of the Authority and authorised for that purpose by the Authority