

# Supplier Forum

## Material changes to National Grid Charging Methodologies – Paper to the GB TCMF

### August 2004

#### Introduction

1. National Grid is obliged, under its transmission licence, to keep charging methodologies under constant review and to propose modifications to them if such modifications can be shown to better meet a set of relevant objectives set out within the licence.
2. These objectives include facilitating competition in the generation and supply of electricity, and also reflecting NGT's costs, where practicable. This framework means that an optimum, overall, view will need to be taken when deciding the best way forward with a particular change proposal – as this may meet one, but not all, of the objectives.
3. However, the constant review can produce charges which better reflect NGT's costs, but also have an effect of introducing an additional level of uncertainty in the market, which can at times inhibit competition and ultimately result in a risk premium being passed to the end customer, ultimately increasing prices.
4. In response to customer needs, several suppliers are now offering a choice of contracts over various durations, including two and three year deals. The actual arrangements will be a compromise between a supplier's desire to protect against the unexpected, and a customer's need for transparent, predictable arrangements that offer an attractive deal.
5. If the supplier has material uncertainty regarding forward costs, it is likely that both the contract, and the billing arrangements, will become more complex, attempting to cover all eventualities. Additionally, it is likely that the supplier will include a risk premium for those events which cannot be reasonably foreseen.
6. For example, under the BETTA scenario, where suppliers in E&W could face material increases in transmission charges of around £1.69 to £2.00 £/MWH, customers are unlikely to willingly understand an explanation that prices have increased because of the inclusion of Scotland, and the simplest way for customers to protest is to withhold a part of their payment.
7. Ultimately these uncertainties are likely to be more difficult for smaller suppliers to handle – for example, a larger supplier who decides to have more sophisticated supply contracts or billing arrangements, in order to hedge against price risk, can spread these relatively fixed costs over a larger volume of energy than a smaller supplier. Similarly, suppliers who have recently entered the market will generally tend to have acquired the more active type of customer, who is more likely to monitor energy prices and switch supplier. Thus the more established suppliers are more likely to be able to pass on, without question, any additional risk premium to a greater proportion of their customers (i.e. to the less active customers).
8. With new generation, there have been persistent calls for financial certainty, in order not to discourage new investment. Inherent in this is a recognition that any increased uncertainty is more likely to discourage new entrants and reduce the opportunities for new competition – certainly it will not assist. The issues are no different for suppliers.
9. In this context it is noted that recent proposed changes to the methodology intended to secure public policy obligations will aggravate other revisions, skewing locational differentials. It is also relevant that it has become conventional that any structural shifts in methodology are implemented coincidentally with commencement of new price controls.

## **Conclusion**

10. Network charging and the frequency of changes to individual transmission customers' charges have begun to distort competition. Larger, more established, players are in a better position to diversify away and manage the associated risks.
11. Where material changes are likely to be introduced to the costs faced by market participants, a minimum of a two year implementation horizon should be adopted.
12. "Material" means different things to different people, but something above inflation, say at around 5% in real terms, might be considered material. Clearly it may not be appropriate to extend the implementation horizon for a change intended to put right an error or discrimination in the charging methodologies.

## **Recommendation**

13. This item is raised as a relevant issue for the GB TCMF to discuss.

**Bob Brown**

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