

## **CMP344 – Addressing the Ofgem Send-Back**

### **Why did Ofgem send-back CMP344**

On 5 May 2021, Ofgem sent back CMP344 and noted the following:

- **Deficiencies of Final Modification Report**
  - *“The submitted FMR has the following deficiencies, which means that we are unable to form an opinion:*
  - *It is not clear from the FMR which OFTO costs the Proposal applies to;*
  - *It is not clear from the legal text which OFTO costs the Proposal applies to; and*
  - *There is therefore no quantitative information regarding how the change impacts each set of network users”*
- **Ofgem’s Expectations**
  - *“We therefore direct that further work is undertaken to address these deficiencies, including:*
    - *The costs and/or events affected by this Proposal clearly set out, with reasoning;*
    - *Analysis of the impact of the reforms on affected parties – to the extent that this Proposal represents a policy change, some indication of the magnitude of change should be presented once the parameters in (1.) above have been set; and*
    - *Legal text which clearly sets out the exact methodology the ESO should follow – in our view the current iteration of the legal text is not capable of being implemented as it is particularly unclear when ESO would be required to move costs into the demand residual. We also expect to see improved consistency between the legal text and FMR.”*
    - *“We require the revised FMR to be very clear about what changes are being made, to explain the impacts on all affected parties and to ensure that the FMR and legal text are consistent”*

### **What approach was agreed at CUSC Panel to address this**

CUSC Panel on 28 May 2021 agreed next steps following send-back on 5 May 2021:

- They noted that Ofgem are asking the Final Modification Report and Legal Text to be revised and resubmitted;
- They agreed that this needs to be assessed by a Workgroup (*there is no Workgroup Consultation, or Workgroup Report and no further Workgroup Alternatives can be raised*);
- They agreed the Workgroup’s Terms of Reference; and

- They agreed (following the assessment by the Workgroup) that a Code Administrator Consultation is needed to be run before it is re-presented to Panel for Recommendation Vote.

### **Agreed Terms of Reference to address Send-Back**

- Consider whether or not the Offshore Transmission Network Review might provide a better forum to propose any changes to the charging arrangements for participants in the OFTO regime
- Clarify in the Final Modification Report which OFTO costs that CMP344 applies to;
- In the Legal Text a) clarify which OFTO costs that CMP344 applies to and b) clearly sets out the exact methodology the ESO should follow;
- Ensure consistency between the Final Modification Report and Legal Text; and
- Provide quantitative analysis as to how CMP344 impacts each set of network users

The Workgroup met on 9 September 2021 and 31 October 2022 to address these Terms of Reference and these discussions and conclusions are set out below:

#### **Consider whether or not the Offshore Transmission Network Review might provide a better forum to propose any changes to the charging arrangements for participants in the OFTO regime**

The Proposer was unclear in which of the Offshore Transmission Network Review (OTNR) workstreams, the issue that CMP344 seeks to resolve would be housed in, and this was echoed by Workgroup Members. The Workgroup also noted that the scope of OTNR is wide and OTNR is still in early stages with the conclusions of the consultation not due to be published until early 2022. Ofgem's July 2021 consultation did not touch on any topic areas that would include the defect that CMP344 has identified. The Workgroup also raised concerns that adding further to the scope of OTNR at this stage would impact its overall purpose deliverability and agreed that it would be prudent for CMP344 to be progressed and considered separately and ahead of the wider OTNR<sup>1</sup>.

#### **Clarify in the Final Modification Report which OFTO costs that CMP344 applies to**

The Workgroup agreed that the scope of CMP344 will be limited to Income Adjustment Events (IAEs).

#### **In the Legal Text a) clarify which OFTO costs that CMP344 applies to and b) clearly sets out the exact methodology the ESO should follow**

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<sup>1</sup> Note that the same evidence was presented by the Proposer to the CUSC panel ahead of CMP344 being returned to the Workgroup.

- a) *The Workgroup agreed that the scope of CMP344 will be limited to Income Adjustment Events (IAEs).*
- b) *In CUSC 14.14.2, the ESO have removed MAR as the term is not used in any licence for example NGENSO only talks about “maximum revenue”. They have also tidied up the final part of 14.14.2 that talks about Kt as it appears to be a general statement but this detail is not required here as it is the licence that determines what can be recovered and licences are clear about Kt and its treatment already. In terms of the rest of the text, ESO have updated that any IAE approved in a particular year will mean the OFTO revenue is adjusted and that is recovered via the Transmission Demand Residual<sup>2</sup> in the following year – which aligns with how the cash flows and the OFTOs get paid via the STC today. There is a carveout though that says “unless otherwise approved by the Authority” which should allow some flexibility should the situation arise where you get to the end of an OFTO set revenue period and an IAE were to be approved – as there isn’t currently a mechanism to deal with adjustments after the period has ended. The ESO Workgroup Member proposed that this risk would be picked up as part of the work on options for the end of the fixed period in which regulated revenues are paid to offshore transmission owners (rather than as part of CMP344).*

Legal Text is set out in Annex 4 of this document.

## Implementation

- In theory, CMP344 can be implemented as soon as practicable after Ofgem approval (if Ofgem approve) as there would not be any impact on revenue collection or tariff setting until the beginning of RIIO 3.
  - Current processes (not codified) would lead to revenue collection from the Transmission Demand residual in the year following an IAE being approved (subject to sufficient timescales to be included in TNUoS tariffs) – Step 1; and
  - Charges are then levied via a generators’ local tariff from the beginning of the next price control – Step 2.
- Under CMP344, Step 1 does not change. However, Step 2 would be removed irrespective of when an IAE might be approved (if CMP344 is implemented). This avoids any risk of need to reopen tariffs, even if an IAE were to be approved prior to CMP344 being implemented. The only caveat is that the above assumes CMP344 is implemented prior to RIIO-3.
- Annex 1 sets out a number of combinations of possible order of events, demonstrating, in the view of the Proposer, that in all reasonable scenarios,

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<sup>2</sup> **“Transmission Demand Residual”** definition (introduced by [CMP340](#)) to be implemented on 1 April 2023 and states: “the total sum of annual Transmission Network Use of System revenue to be recovered through the Transmission Demand Residual Tariffs from Final Demand Sites and Unmetered Supplies only”

revenue collection in the current price control is unaffected by when CMP344 is implemented.

- Although, the Workgroup agreed that implementation does not have to be timed for a 1 April date, the Workgroup noted that the definition of “Transmission Demand Residual” will only be implemented on 1 April 2023. Whilst it is possible to use the current definition of “Transmission Network Use of System Demand Charges” and then raise a further Modification to change this to “Transmission Demand Residual”, on balance this was thought unnecessary given the likelihood of an IAE approval and/or CMP344 approval before 1 April 2023 in the current climate.

### **Ensure consistency between the Final Modification Report and Legal Text**

To be checked in Final Modification Report before being issued to Ofgem

### **Provide quantitative analysis as to how CMP344 impacts each set of network users**

#### **Background and Scope**

Following extensive investigation to identify if ESO was able to carry out the relevant analysis, or commission it directly, The Proposer commissioned Cornwall Insight to carry out relevant analysis. This was to establish the impact of the treatment of TNUoS charges and potential IAEs by offshore wind generators and the implications these have for consumers noting that CMP344 proposes that the additional revenue allowances for OFTOs in relation to IAEs should be recovered from all demand users, rather than the generator directly affected. Cornwall Insight considered the implications that this would have for TNUoS charges and the effects on CfD strike prices.

The full analysis and covering slides are included as Annex 2 and Annex 3 respectively.

#### **Assumptions Made**

The assumptions made by Cornwall Insight were:

- There have been five claims for Income Adjusting Events (IAEs) since the OFTO regime was established. Of the IAE claims to date, four applications have been rejected by Ofgem and the other is pending. Although four IAE applications were deemed ineligible by Ofgem, the claim cost information is likely to be consistent with costs and circumstances for an eligible outage claim. This is the information that would be available to investors in generation assets for risk modelling purposes. The mean average of the claims cost is £9.48m, while the median is £10.95m. **For modelling purposes, the cost of an eligible IAE will be deemed to be £10m.**
- **Have approximated the impact of an IAE on a CfD risk premium by including IAE applications’ costs as an additional OPEX cost for generators and included in a Levelised Cost of Energy (LCOE) calculation.** Noted though that Generators will have differing bidding

strategies which add a layer of complexity to bids over and above the relatively simple Levelised Cost of Energy (LCOE) calculation carried out.

- The risk of IAEs being approved is low, with none having been finalised to date. But because of the high impact an IAE could have on an investment, generators must factor them into bids. **Have used three cases to quantify this:**
  - **Low - assuming an event occurs every 1 in 250 years.**
  - **Central - assuming an event occurs every 1 in 50 years**
  - **High – assuming an event occurs every 1 in 15 years**
- Considering the significant scope for different factors to influence the relative value over time (both positively and negatively), **have assumed the IAE value remains constant over the given period**
- **Used an example 1.5GW site in order to show the impact on future assets as the market grows.**
- **CfD strike prices are quoted in 2012 equivalent figures to maintain comparability with CfD Allocation Round 1 in 2014**
- **Results are inflated to today's money when calculating the consumer impact**
- **Used the [BEIS Levelised Cost of Energy](#) (LCOE) data to inform their analysis on load factors and asset costs when determining the strike price**

## **Methodology**

Cornwall Insight's approach to this analysis was as follows:

- Reviewed the IAE applications submitted to Ofgem to date to inform potential additional TNUoS costs which would be incurred by generators under current arrangements;
- Undertook a high-level review of subsidy bidding strategies (e.g., CfDs) in relation to the treatment of risks beyond a bidder's control; and
- Taking central, high and low cases for generator assumptions on the likelihood of an IAE impacting their operation, modelled the impact of IAEs TNUoS risk on CfD costs. This considered how much generator CfD bids (required strike prices) would change if they did not need to take into account the impact of TNUoS costs related to IAEs.

## Conclusions from Cornwall Insight

- IAE claims have been rare, and none have been approved by Ofgem so far. However, the risk of IAEs occurring is likely to be impacting the prices ultimately paid by consumers.
  - Based on generators taking an assumption of a 1 in 50 (central case) chance of an IAE with a £10m TNUoS impact occurring in any given year, Cornwall Insight estimate
    - the TNUoS risk of IAEs for generators increases CfD strike prices by £0.03/MWh;
    - For anticipated CfD Allocation Round 5, 6 and 7 assets alone the total benefit to consumers of applying CMP344 would be ~£50m over the lifespan of their CfDs. If precedent continues and no IAE claims are approved, there is no offsetting cost to consumers – CMP344 is “upside only”.
- If an IAE were to occur, there would be a short-term cost to consumers under the CMP344 solution. If CMP344 were not approved, generators would increase risk premia as a result of an IAE being approved. Even when accounting for time value of money (the cost is upfront while the CfD benefit accrues later), the benefit of removing additional risk premia more than offsets the cost.
- CMP344 only removes one element of offshore cable outage risk. A significant cost to developers will remain from lost productivity in the event of a cable failure. Hence developers will remain heavily incentivised to construct offshore infrastructure to high standards of reliability. CMP344 will not meaningfully diminish this incentive. The additional risk to generators from exposure to IAE expenses is not a useful market signal.

The following table summarises the Impacts and further detail can be found in the full analysis (Annex 2) and covering slides (Annex 3).

# CMP344 Impact Summary

If an IAE were to occur under CMP344, consumers would pay more in the short term. But the counterfactual without CMP344 would see generator risk premia increase as generators would perceive an increased IAE risk. So, in the long run consumers would still be detrimentally impacted.

	No IAE	An IAE occurs
CMP344 adopted	<p>Ideal outcome- no consumer cost in TNUoS or CfDs</p> <ul style="list-style-type: none"> <li>• No recovery required</li> <li>• Future CfD risk premia related to IAEs removed</li> <li>• Consumers benefit overall</li> </ul>	<p>Good outcome –consumers face upfront cost of IAE but no reactive increase in future CfD costs</p> <ul style="list-style-type: none"> <li>• Permitted costs recovered from all demand users via TNUoS, consumers pay more short term...</li> <li>• ...but CfD IAE related risk premia remain zero</li> <li>• Consumers benefit overall</li> </ul>
CMP344 rejected	<p>Poor outcome –consumers fund risk premia in bids despite no cost ever being incurred</p> <ul style="list-style-type: none"> <li>• No recovery required</li> <li>• Consumers continue to fund CfD risk premia</li> <li>• Consumer detriment overall</li> </ul>	<p>Poor outcome– customers still exposed to upfront costs (albeit paid back in RIIO) as well as to reactive increase in CfD risk premia</p> <ul style="list-style-type: none"> <li>• Permitted costs recovered from Generator</li> <li>• Consumers save in short term...</li> <li>• ...but CfD risk premia increase based on higher perceived IAE risk Consumer detriment overall</li> </ul>

Source: Various, compiled by Cornwall Insight

## Workgroup thoughts on Conclusions

Workgroup welcomed the analysis provided and concluded that this addresses the asks from Ofgem to set out what the benefit could be of implementing CMP344. The ESO Workgroup Member suggested that benefits depend on your view as to whether or not risk premia will always be applied if CMP344 is rejected.