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Dear Colleague,

Decision to reject an appeal by Muirhall Energy Limited against a self-governance decision of the CUSC Panel regarding CMP342

On 2 October 2020, we received notice of an appeal by Muirhall Energy Limited ("Muirhall") in accordance with Paragraph 8.25.14 of the Connection and Use of System Code ("CUSC").¹ This appeal was made in respect of the decision of the CUSC Panel, on 28 August 2020, to approve CUSC modification proposal CMP342 'Clarification of VAT for Securities in the CUSC' ("Proposal").² Muirhall is the only party to appeal this decision.

Having duly considered the arguments and evidence submitted by Muirhall and the Proposer, we have decided to reject the appeal. This letter sets out our reasoning for our decision and advises the parties on next steps.

Background

The original Proposal (CMP342) was raised by National Grid Electricity System Operator ("Proposer"). The Proposal seeks to clarify that when calculating the amount Users are required to secure under the CUSC, the amount of applicable Value Added Tax ("VAT") is to be included. The Proposer considers that the Proposal will better facilitate the applicable CUSC Objectives as it clarifies the position on securities, allowing them efficiently to

¹ References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work.

² CMP342 and related papers are available here: <https://www.nationalgrideso.com/industry-information/codes/connection-and-use-system-code-cusc-old/modifications/cmp342>

administer the securities processes and ensure all Users secure on a consistent basis, protecting other Users, and ultimately consumers.³

The Proposer's view was that the modification should be considered as a self-governance proposal pursuant to Paragraph 8.25 of the CUSC. The CUSC Panel, in May 2020, unanimously agreed that the Proposal should follow the self-governance route and proceed to Code Administrator Consultation. At the July 2020 CUSC Panel, the Proposer (who is also the Code Administrator for the CUSC) said that a respondent to the Code Administrator Consultation had challenged the decision to follow the self-governance procedure. Therefore, the CUSC Panel agreed to defer decision on the appropriate governance route until the August 2020 CUSC Panel.

The Proposer shared the representation with the Authority and asked if we wished to change the governance route for the Proposal. Based on the information provided, we did not exercise our power in this regard, and were content for the CUSC Panel to decide.

At the August 2020 CUSC Panel, the CUSC Panel agreed by majority to maintain their decision that the Proposal should follow the self-governance route. The CMP342 Final Self-Governance Report highlights that on 28 August 2020 the CUSC Panel, by majority, determined that the proposal better facilitates the applicable CUSC Objectives than the status quo and should be implemented. The CUSC Panel's decision was published on 11 September 2020.

Permission and procedure for determining the appeal

Muirhall submitted an appeal against the CUSC Panel's decision to implement the Proposal on 2 October 2020. On 2 November 2020, we said that we were satisfied that Muirhall met the criteria for permission to appeal that are set out in the CUSC.⁴ However, in granting permission to appeal the CUSC Panel's self-governance decision, we confirmed that we had not yet assessed the merits of the appeal itself. A redacted version of the appeal is available on our website alongside our letter confirming it is a valid request for an appeal.

We invited any interested parties to make a written representation in respect of the appeal to do so by 16 November 2020. We received one representation and a redacted version of that has been published on our website. Following this, we received one further representation on 25 November 2020. A redacted version of that representation has also been published alongside the original representation.

³ The CUSC Objectives are set out in Condition C10 of the electricity transmission licence.

⁴ <https://www.ofgem.gov.uk/publications-and-updates/cmp342-clarification-vat-securities-cusc-notice-appeal-against-self-governance-decision>

Our assessment of the appeal

Muirhall's appeal is raised on two grounds:

- (a) **The self-governance route decision:** Muirhall says that the Proposal does not meet the Self-Governance Criteria under the CUSC and should instead have been proposed by way of the standard modification route. Specifically, Muirhall argues that the Proposal will have a material impact on competition, in that including VAT in calculation of secured amounts would involve small and medium-sized generators tying up substantial funds for up to seven years before completion of a project, so depriving them of the ability to use funds to develop their operations and compete against larger competitors. It also argues that the Proposal will lead to discrimination between different classes of CUSC parties, in that relatively smaller companies are more likely to have to post security in cash or by costly letters of credit (rather than by guarantees) and their development opportunities are likely to be stifled.

- (b) **The CUSC Panel's decision on the Proposal:** Muirhall says first that it would be unfairly prejudiced because of the effects of the Proposal in tying up its funds. It then argues that the Proposal would not better facilitate the achievement of the CUSC Objectives, in that (i) distortion of competition and discrimination between different classes of generators will not assist in efficient discharge of regulatory obligations; (ii) such effects will not facilitate effective competition; (iii) they will not assist in compliance with the Electricity Regulation (EU/2019/943); and (iv) the Proposal will not promote efficiency in the implementation and administration of the CUSC arrangements. Muirhall further maintains that its appeal is brought on proper grounds.

Following the grant of permission to appeal, on 16 November 2020, the Proposer put in written representations, arguing in response to Muirhall's appeal that: (i) the self-governance modification process was appropriate, since the Proposal sought to achieve clarification of provisions rather than fundamental change; (ii) the addition of VAT when calculating the secured amount was appropriate; and (iii) rejecting the Proposal would be to leave the treatment of VAT ambiguous and create uncertainty for the market.

On 23 November 2020, Muirhall responded to those representations. It maintained its position that the Proposal had been put forward to codify a practice which the Proposer had introduced to the market and which had a real cash cost to smaller operators. It argued further to this, that if the Proposal was rejected, the industry would provide financial

security in accordance with the existing provisions of the CUSC, which it asserted do not provide for VAT to be included in the calculation.

Having duly considered all of the arguments submitted by the parties by reference to the existing provisions of the CUSC and the Electricity Transmission Standard Licence Conditions ("SLT"), we have concluded that that the appeal raises the following issues to be determined by the Authority in its decision-making capacity under Paragraph 8.25 of the CUSC:

- (a) **Issue 1:** The effect of the current CUSC provisions regarding whether or not VAT is to be included in the calculation of the secured amount, and whether the Proposal represents a substantive change or merely a clarifying amendment;
- (b) **Issue 2:** Whether or not the CUSC Panel was correct to follow the self-governance route in respect of the Proposal; and
- (c) **Issue 3:** Whether or not the CUSC Panel's decision on the Proposal was substantively justified, that is, whether the Proposal better facilitates the CUSC Objectives than the existing provisions, as is stated in Paragraph 8.25.15 of the CUSC.

Issue 1 - The effect of current CUSC provisions regarding inclusion of VAT, and whether the Proposal represents a substantive change or merely a clarifying amendment

The first issue to be considered is the effect of the current CUSC provisions (ie, without the Proposal being implemented). As regards the drafting of Part 15 of the CUSC, we make the following observations:

- (a) Paragraph 3 of Part 3 provides that (i) prior to the Trigger Date, the Cancellation Charge Secured Amount will be "the Cancellation Charge as set out in the Cancellation Charge Statement" (ie, 100% of the Cancellation Charge); and (ii) from the Trigger Date, the Cancellation Charge Secured Amount will be a percentage of "the figure shown as the Cancellation Charge in the Cancellation Charge Statement" (ie, a lesser percentage of the Cancellation Charge).
- (b) The Cancellation Charge is defined in Section 11.3 of the CUSC as being the charge payable in the event of termination. That definition indicates that VAT is to be taken into account, since the sum actually payable as the Cancellation Charge would have to include VAT (see below in relation to incidence of VAT).

- (c) Part 2 of Section 15 of the CUSC provides the set of formulae for calculating the Cancellation Charge. Paragraph 1.2 of that Part states in terms that VAT is payable on any Cancellation Charge, which further supports the view that the Cancellation Charge should take account of VAT.

In our view these provisions ought to be interpreted in context as meaning that the secured amount should take account of VAT (ie, that it should include the VAT which would be payable as part of the Cancellation Charge). Whether adopting the tools of statutory or contractual interpretation, the context and apparent purpose of the provisions need to be taken into consideration. As set out below, the policy context strongly favours including VAT in the calculation.

Focusing only on the wording of the provisions without regard to their context and purpose, Cancellation Charge is defined as the sum actually payable (which expressly includes VAT), and the sum to be secured is to be calculated by reference to that amount. The Cancellation Charge Statement referenced in the provisions is only a means of documenting the Cancellation Charge. Muirhall has pointed out that the standard blank form of Cancellation Charge Statement exhibited to the CUSC does not include an express reference to VAT. However, that does not prevent the Cancellation Charge, which is defined as the sum actually payable on cancellation, from being a figure which includes VAT.

Further, any assessment of the effect of the CUSC provisions needs to be undertaken in the context of the application of VAT rules by HMRC. Our understanding is that, referring to page 13 of Appendix 2 to Muirhall's appeal notice (email from HMRC to NGESO, dated 12 March 2020), the deposit of a sum by way of security does not trigger a liability for VAT. This makes sense, insofar as the posting of security is akin to a returnable deposit (not part payment or a deposit against services to be provided at a future date).⁵ However, critically, a Cancellation Charge actually levied would attract VAT, which is why Section 15 Part Two Paragraph 1.2 of the CUSC provides for VAT to be payable on such a charge. It is natural for a sum to be posted by way of security to be calculated by reference to the liability which it is required to secure. That liability includes VAT in this case.

That reading of the relevant provisions (ie, that VAT is to be included when calculating the secured amount) appears to be more consistent with the policy objective of the security regime. The purpose of the regime is to ensure that an appropriate proportion of the Cancellation Charge applicable to a User in each year is covered by security, in order to reduce the risk of bad debts having to be met by other network participants and ultimately

⁵ See HMRC Guidance on VAT: instalments, deposits, credit sales: <https://www.gov.uk/guidance/vat-instalments-deposits-credit-sales>

passed on to consumers. NGESO would be requesting an insufficient level of security if the proportion was calculated by reference to a figure lower than the actual Cancellation Charge which the User would have to pay in the event of cancellation.

The methodology that is used to determine individual Generators' liabilities, and the level of securities required against these liabilities, was introduced by CMP192 'Arrangements for Enduring Generation User Commitment'.⁶ The content of the CMP192 decision document, moreover, strongly indicates that the percentages fixed for calculating secured amounts are intended to relate to the entire sum which would be payable on cancellation (ie, the Cancellation Charge including VAT). Notably, at page 3 of that decision, it states that: "[p]rior to four years before the commissioning date, the required securities would be 100% of the liabilities".⁷ In context, that must be a reference to actual liabilities of the User in the event of cancellation (not some lesser figures). As set out above, those liabilities would always be inclusive of VAT.

It is noted that, had we concluded that the CUSC does not provide for VAT to be included when calculating the secured amount, then the Proposal would be one for a substantive change that significantly increased liabilities of generators in posting security. As set out above, Muirhall argues that such an increase would materially affect competition and discriminate between different classes of market participants.

However, as we have found above that the CUSC does already provide for VAT to be included when calculating the secured amount, it is our view that the Proposal is proposing no more than clarifying amendments. It follows, bearing in mind what we have said above, that the Proposal does not have any effect on competition or any discriminatory effect.

Issue 2 - Was the Panel correct to follow the self-governance route?

The next issue to be considered is whether or not the CUSC Panel was correct to follow the self-governance route in respect of the Proposal. The Self-Governance Criteria are relevantly defined (in Section 11.3 of the CUSC and also in Condition B12, Paragraph 16, of the SLT) as meaning that a proposal, if implemented:

- "(a) *is unlikely to have a material effect on:*
 - (i) *existing or future electricity consumers; and*
 - (ii) *competition in generation, distribution or supply of electricity (or in connected activities); and*

⁶ <https://www.nationalgrideso.com/industry-information/codes/connection-and-use-system-code-cusc-old/modifications/cmp192>

⁷ <https://www.ofgem.gov.uk/publications-and-updates/connection-and-use-system-code-cusc-cmp192-national-grid-proposal-enduring-user-commitment-arrangements>

- (iii) *the operation of the national electricity transmission system; and*
 - (iv) *matters relating to sustainable development, safety or security of supply or management of market or network emergencies; and*
 - (v) *the CUSC's governance or modification procedures; and*
- (b) *is unlikely to discriminate between different classes of CUSC parties”.*

The self-governance criteria are, in summary, intended to ensure that only modifications with a relatively limited effect are made by the CUSC Panel without the approval of the Authority.⁸

Had we been of the view that the existing CUSC does not provide for VAT to be included when calculating the secured amount, it would have followed that the Proposal significantly increased liabilities of generators in posting security. Thus, had we found differently in relation to Issue 1, we would have found that the use of the self-governance route was inappropriate.

However, as we have said, our conclusion is that the current CUSC does provide for VAT to be included when calculating the secured amount, and so the Proposal is proposing no more than clarifying amendments. Accordingly, it cannot be said that the Proposal has any effect on competition or any discriminatory effect. Further, as the Proposal does no more than clarify the existing effect of CUSC provisions, it is not a proposal which materially affects the interests of market participants.

Issue 3 - Was the Panel's decision on the Proposal substantively justified?

The final issue for consideration is whether the substantive decision of the CUSC Panel was appropriate in the circumstances. This question is to be determined by asking whether the Proposal better facilitates the CUSC Objectives than the existing provisions, as is stated in Paragraph 8.25.15 of the CUSC.

Paragraph 1 of Condition C10 of the SLT identifies the four CUSC Objectives:

- "(a) *efficient discharge by the licensee of the obligations imposed upon it under the EA89 and by the licence;*
- (b) *facilitating effective competition in the generation and supply of electricity, and (so far as consistent therewith) facilitating such competition in the sale, distribution and purchase of electricity;*

⁸ See further Section 8, Paragraph 8.25, of the CUSC.

- (c) *compliance with the Electricity Regulation (EU/2019/943) and any relevant legally binding decision of the European Commission and/or the EU Agency for the Co-operation of Energy Regulators; and*
- (d) *promoting efficiency in the implementation and administration of the CUSC arrangements”.*

Condition C10 requires procedures to be put in place for modification of the CUSC which involve the CUSC Panel deciding upon specific modification proposals.

As we have found above that the Proposal serves to clarify provisions which already require VAT to be included in the calculation of a secured amount, rather than proposing a substantive change, it is our view that the Proposal better facilitates the applicable CUSC Objectives compared to the status quo (considering the Objectives in totality). Specifically, as to Objective (a), the Proposal assists in the efficient discharge of the obligations of the Proposer if the application of VAT to the secured amount is stated clearly in the text of Part 3 of Section 15, so avoiding unnecessary confusion or dispute. As to Objective (d), it promotes efficiency in the administration of the CUSC arrangements if the calculation of the secured amount is clear on the face of the Code. We find the Proposal to be neutral as regards objectives (b) and (c).

We consider that the above conclusions are determinative of the appeal, and mean that it should be rejected. However, for completeness, we have also gone on to consider the Proposal on an alternative basis: would it be substantively justified if the amendments being proposed were not merely clarifying amendments?

Had that been our conclusion, a change from a regime which did not require VAT to be included in the calculation to one which did require VAT to be included could not have been classed as a self-governance proposal. In that case, the CUSC Panel would only have made a recommendation and referred the proposal to the Authority for a final decision. The Authority would then have made its decision based on the relevant CUSC Objectives.

Our view is (based on the evidence that has been presented in the code modification proposal and through submissions to this appeal) that, in that situation, this would still have been a change that better facilitated CUSC Objective (a) ('efficient discharge of the licensee's obligations') and Objective (d) ('promoting efficiency in CUSC arrangements') by clearly setting out the requirements on Users and avoiding the possibility of dispute or confusion. It would, however, also have affected Objective (b), that of 'facilitating effective competition in generation and supply of electricity'.

In that regard, a substantive change from a regime in which VAT was not included to one in which VAT was included would appear to have effects both supportive of and detrimental to effective competition:

- (a) On one side of the balance, the change would encourage effective competition in that it would reduce the risk and incidence of bad debts of some generators being passed on to other Users as a group. Competition in the market for electricity generation is not encouraged where the risk of hazardous projects failing is passed to other market participants. Furthermore, adding to the costs of other generators may have downstream effects on competition in the sale and purchase of electricity by raising wholesale prices. We consider that the policy decisions made by CMP192 and CMP223⁹ envisaged VAT being included in the calculation of secured amounts as it contributes to the total liability faced by market participants. Those decisions formed part of a carefully balanced package of measures designed to balance the need to maintain an open market for new generation projects against the need to protect existing participants against paying for failed projects through higher network charges.

- (b) On the other side of the balance, as Muirhall has argued, including VAT in the calculation of secured amounts materially increases the sums for which security must be provided. That, in turn, has the effect of tying up additional capital resources of small and medium-sized generators, which have to post security either in the form of cash deposits or in the form of a letter of credit. The impact of this can therefore be different between such Users and larger competitors in that the latter may provide security in the form of guarantees by themselves or their parent companies.

On the basis of the evidence we have seen, if we had concluded that the Proposal actually served to change provisions of the CUSC, we would have concluded that the Proposal would still be conducive to effective competition and would better serve CUSC Objective (b). Our principal reason for this view is that the Proposal would be consistent with the carefully balanced package of measures which was designed to promote effective competition by preventing bad debts relating to failed projects from being met by other market participants. Furthermore, and taking into account that Muirhall and other small and medium-sized generators have provided security in this way until the Proposal was raised, we have not seen evidence to suggest it is detrimental to effective competition.

⁹ <https://www.ofgem.gov.uk/publications-and-updates/connection-and-use-system-code-cusc-cmp223-arrangements-relevant-distributed-generators-under-enduring-generation-user-commitment-0>

For the avoidance of doubt, even if the Proposal was more than merely clarificatory in effect, our view based on the evidence base we have seen is that it would still have been neutral in respect of CUSC Objective (c) ('compliance with the Electricity Regulation').

Our decision and next steps

Having carefully considered the arguments put forward by Muirhall, and subsequent representations received, our view is that:

- The Proposal is a clarifying amendment, rather than a substantive change;
- The Panel was correct in deciding to follow the self-governance procedure for the Proposal; and
- The Panel was substantively justified in deciding to approve the Proposal.

We have therefore decided to reject the appeal for the reasons we have set out in this letter. The Authority, in accordance with Paragraph 8.25.19 of the CUSC, therefore confirms the Panel's decision to approve the Proposal and that it should be implemented.

The original Proposal intended implementation of the change to take place five (5) working days after the appeal window closed, providing no objections were raised. That date has now passed and the CUSC is silent on implementation following an appeal against a self-governance decision. The Authority therefore directs that the Proposal is implemented five (5) working days from the date of this letter.

Yours faithfully,

Andrew Self

Deputy Director, Electricity Network Charging and Access