

# UKERC response to Ofgem Call for Input on Locational Charges and Regulatory Siting Levers Under Reformed National Pricing

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## About UKERC

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## Q1. Do you agree with our assessment criteria for locational charging options?

We disagree. We believe that “**reducing costs for consumers**” should be a distinct assessment criterion. Driving value for customers should be a primary concern of policy, and we believe that having this as an explicit assessment criterion would create a strong case for taking a differentiated approach to TNUoS that is not currently considered in Ofgem’s call for input document.

We agree that TNUoS is an important instrument to achieve its primary purpose of sending locational signals to the market relating to network costs, helping to steer investment decisions for merchant plant. We also agree that, as set out in the call for input document, there are good reasons for considering TNUoS reform options.

However, we make the case that TNUoS charges for CfD plant should be set differently in order to achieve the best value for consumers. Specifically, TNUoS should be set to a flat

rate (or zero) across all zones for CfD plant, and be replaced with locational signals (either volume- or price-based) within the auctions themselves. There are three reasons for taking this approach:

- **Reducing inframarginal rent.** Firstly, locational CfD auctions will be more effective at reducing consumer costs by reducing inframarginal rent than TNUoS which is not designed for this purpose.
- **Reducing risk and complexity.** There could be reduced complexity and risk for investors in having a single instrument for each policy objective, which ultimately could also bring down consumer costs.
- **Improved deliverability.** Locational CfDs can be simple and quick to introduce (they were already used in AR7), allowing near-term CfD auctions to proceed whilst giving time to get more complex TNUoS arrangements right for the task for which they were designed for merchant plant.

Specific consideration of the impact of TNUoS on the consumer cost of CfD auctions is justified because CfDs will provide the principal route to market for most large-scale renewable generation investments at least until the early 2030s. They therefore should be a key point of focus for policy because they mobilise substantial allocations of capital, locking in elements of consumer bills over the duration of their long-term contracts, and are therefore key to reaching the objective of reducing consumers' exposure to high and/or volatile gas prices. The above three points are outlined in more detail below.

### **Reducing inframarginal rent**

Inframarginal rent in CfD auctions is caused by cost differentials between regions, e.g. due to resource differences, ease of project development or other factors. It can also be created by TNUoS differentials. For example, in AR7, a locational auction design was introduced for offshore wind because of the potential for high TNUoS charges in Scotland to lead to raised GB-wide CfD strike prices.

If inherent project cost differentials between regions are known before the auctions are held, then there is a strong case for policy to be designed to minimise these rents. The logic of driving planning through a centralised SSEP process implies that indeed, these cost differentials are, at least to some degree, predictable, as they would show up as shadow costs in the model.

We therefore argue that minimising inframarginal rent should be a primary objective of the design of locational levers. As we have argued in our DESNZ RNP consultation response:

- **TNUoS** is not primarily designed to address inframarginal rent. It can have positive or negative impacts on inframarginal rent because it only represents some of the inherent locational cost differentials between regions, so is an imprecise way to correct inframarginal rents within CfD auctions. The impact will depend on specific TNUoS designs, so if minimising inframarginal rent becomes an objective of TNUoS design, this may distort design choices for TNUoS, as it is not primarily designed for this purpose.
- **Locational CfDs** by contrast would have the primary objective of minimising inframarginal rent, giving more flexibility over their design and the charges that are

introduced. This could be done through volume-based approaches (e.g. use of maxima or minima as per the AR7 auction) or through a price-based approach that aims to correct for inherent locational price differentials but maintains a single national auction with a single clearing price.

We therefore believe that locational CfDs should be used as the principle mechanism for providing locational signals for CfD plant. In the case of CfD plant, TNUoS would be applied as a non-locational charge, either set to zero or to a flat rate for all locations. As we argue below, this differentiated TNUoS charge could be introduced without distorting the locational signals for other generators.

### **Reducing risk and complexity**

TNUoS currently suffers from considerable volatility leading to the introduction of risk premia into CfD auctions. This could be solved by fixing TNUoS for the duration of the CfD contracts.

We advocate going a step further to **fix TNUoS either at zero or at some other flat rate** for projects with a CfD contract in all locations. Subsequent analysis could be undertaken to assess the optimal rates given the split of payment between producers and consumers.

This would have advantages:

- Reduces risk by creating greater levels of certainty in operating costs and net revenues;
- Reduces complexity by having a single instrument to signal location in CfD contracts. Currently, there are cases where both TNUoS and locational CfDs are needed together to address locational signalling and inframarginal rent corrections.
- Depending on the chosen TNUoS model, locational CfDs may be less complex to design.

We are not advocating abolishing locational TNUoS for merchant plant. We believe it performs an important role in the market by providing locational signals to merchant generators, storage and other market players. TNUoS reform could consider ways in which longer-term contracts for these charges could be developed in addition to the standard variable rates to support risk management for longer-term merchant investment.

It is important to note that merchant plant operating under differentiated locational TNUoS rates would not be at a significant competitive disadvantage to CfD plant operating on a zero or flat-rate TNUoS charge applied at the point of auction. This is because they do not compete in the same market. Each CfD auction round is effectively a separate competition, largely isolated from other auction rounds and from the wider wholesale market.

In order to allow merchant plant the same degree of certainty over locational prices that CfD plant would enjoy, it would be worth considering offering long-term fixed TNUoS contracts for merchant plant that would fix charges at the point of final investment decision. This would help manage risks and reduce investment costs.

### **Improved deliverability**

We believe that our proposal would help to simplify and accelerate the implementation phase of RNP and TNUoS reform by separating out the two key functions of locational

signalling; directing merchant investment on the one hand, and holding cost-effective CfD auctions on the other.

TNUoS reform is likely to be a complex process, and sufficient time is needed to ensure that it is designed well for the long-term functioning of the market. Splitting out these processes would allow TNUoS reform to proceed without having to address the potential side effects on inframarginal rent – an objective for which it was not designed.

In the meantime, CfD auctions need to proceed to ensure the procurement of sufficient renewable power. Setting TNUoS to a flat rate for CfD plant would be a simple measure to implement. Replacing it with a locational CfD could also be simple to implement, depending on the design chosen. AR7 was an example of a volume-based locational CfD auction using minima to split the clearing price between locations – so experience has already been gained of implementing this mechanism. Alternative price-based mechanisms have not been used to date, but in principle would act in a similar way to current locational charges, but with more flexibility to set locational price adjustments to appropriate rates independently of the TNUoS reform process, and with improved outcomes for inframarginal rent.

Whilst we would see this proposal as being a helpful simplification, it nevertheless requires strong coordination between Ofgem's TNUoS reform options that are being considered in this call for input, and DESNZ's consultation on the locational siting and investment levers being considered under the wider RNP delivery plan.