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Dear Cheryl

Transmission Access Review – Enhanced transmission investment incentives: initial proposals

Scottish Hydro Electric Transmission Limited (SHETL) welcomes Ofgem's initial proposals for the funding of transmission investments which will reduce or remove existing grid-related barriers to the connection of new generation. We agree that a simple, pragmatic funding approach is appropriate at this time given the ongoing developments in transmission access and review of regulatory arrangements. Hence, we support Ofgem's proposals to fund costs up to the end of Transmission Price Control Review (TPCR) 4 on the basis of annual allowances determined ex ante.

Assessment of projects

In respect of the six transmission investment projects nominated by SHETL for funding in 2009-10 and 2010-11, we welcome and support the initial view of Ofgem's consultants that there is a positive case for Knocknagael, Beauly-Dounreay and Beauly-Blackhillock-Kintore. These projects will result in additional transmission capacity to the north of the currently constrained northwest (B1) boundary. We agree that there is strong justification for funding the construction of these projects in 2009-10, 2010-11 and beyond, and this funding should be the subject of the final proposals.

We recognise that there remain some issues to be resolved in respect of Kintyre-Hunterston, Western Isles and Shetland. For Kintyre-Hunterston, we welcome and support the initial view that there is a positive case for the reinforcement, but acknowledge that the design of the project is to be finalised. For the two island links, there is a clear interdependency between the transmission infrastructure and the contingent generation developments which do not yet know the outcome of their applications for planning consents.

Given these outstanding issues for these three projects, we understand that Ofgem's consultants remain to be convinced about the strength of the case for providing construction funding in 2010-11. However, in the event that these issues cannot be resolved by the final proposals in mid January 2010, we welcome Ofgem's intent to consider these projects again when further information becomes available. In this regard, a key element of the final proposals must be to set out the process by which Ofgem will review these projects to ensure that funding arrangements can be determined in a timely and efficient manner consistent with the delivery timescales of the reinforcements.

Proposed funding framework

SHETL supports the initial proposal to adopt a simple, pragmatic approach to funding the pre-construction and construction of necessary transmission investments during TPCR4.

We agree that, for eligible projects where the needs case has been demonstrated, construction funding should be provided based on the following principles:

- § annual allowances determined ex ante, and supplementing the existing TPCR4 capital expenditure allowance;
- § specific Income Adjusting Event provisions; and
- § capital expenditure efficiency incentive.

The TPCR4 capital expenditure incentive revenue adjustment is not easily modified to allow for the introduction of additional capital expenditure allowances. Hence, rather than 're-open' this adjustment mechanism, we support a stand alone capital expenditure efficiency incentive for eligible projects. For funding allowances in TPCR4, this mechanism should result in an incentive payment or debit to the TPCR5 settlement either as a single 'NPV' adjustment or yearly 'roller' adjustments. We believe that the 75:25 ratio of pass-through to incentivised costs remains appropriate. Given the scale of these investments relative to the transmission businesses, we believe there is merit in considering a cap and collar on the resultant incentive payment or debit.

In general, we support the proposal to make allowances for eligible projects up to the end of TPCR4 (that is, for 2009-10, 2010-11 and 2011-12). However, we note that a number of projects will commence construction during TPCR4 but not be completed until TPCR5. For these projects, we would support the application of the same funding arrangements in TPCR4 and TPCR5 to ensure that the balance of regulatory risk remains the same as when the

investment decision was made. In addition, there are potential perverse consequences of undertaking an efficiency assessment (and application of a capital expenditure efficiency incentive) midway through the construction period. The treatment of partially complete projects needs to be considered in the design of the capital expenditure efficiency incentive through, for example, linking expenditure to project milestones where the efficiency assessment is undertaken as and when those outputs have been delivered.

I hope these comments are helpful. Please do not hesitate to get in touch if you wish to discuss any aspect of this response further.

Yours sincerely,

Rob McDonald
Director of Regulation