Consultation on Scottish Hydro Electric Power Distribution (SSEH's) Shetland Energy Costs recovery arrangements

Consultation

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Contact: Rory McCarthy, Senior Policy Analyst

Team: Distribution Policy

Tel: 020 3263 9684

Email: rory.mccarthy@ofgem.gov.uk

Overview:

We are consulting on changes we would like to make to the cost recovery arrangements that relate to Scottish Hydro Electric Power Distribution's (SSEH's) Shetland Energy Costs. This document presents the background to why changes to these recovery arrangements are necessary. Firstly, we are seeking views on the policy and licence changes required. Secondly, we are seeking views on the forecast costs which SSEH will be allowed to recover.

Context

In Distribution Price Control Review 5 (DPCR5) we allowed SSEH to recover some of the higher costs of electricity generation on Shetland through its licence. These arrangements allowed SSEH to spread the high cost of energy on Shetland among all SSEH's north of Scotland customers. This should be continued for the next price control period, RIIO-ED1, to enable SSEH to provide energy for the customers on Shetland.

We are currently in the process of finalising RIIO-ED1 determinations for the slow track distribution companies. In our draft determinations consultation, published on 30 July 2014 we stated that Shetland costs would be dealt with on the basis of the mechanism in SSEH's DPCR5 licence.[1] Since the publication of the RIIO-ED1 draft determinations, we have received updated cost submissions from SSEH for the recovery of its Shetland Energy Costs. As a result we need to update the arrangements for Shetland's costs.

This consultation is running alongside our consultation on the draft licence conditions (CRCs) that will apply to all DNOs for RIIO-ED1[2]. The proposals in this consultation will ensure the recovery arrangements and amounts in relation to Shetland can be agreed before the final determinations for the RIIO-ED1 price control period. These changes are designed to ensure value for consumers' money.

Associated documents

Documents published alongside this consultation

- Supplementary Annex 1: Draft CRC licence changes for SSEH's Shetland Energy Costs
- Supplementary Annex 2: Draft ED1 Price Control Financial Handbook

Other relevant documents

- Strategy decision for RIIO-ED1 – Overview
- RIIO-ED1: Informal consultation on slow-track licence drafting – Charge Restriction Conditions
- RIIO-ED1 Glossary

[1] RIIO-ED1: Draft determinations consultation for the slow-track electricity distribution companies, 30th July 2014

[2] RIIO-ED1: Informal consultation on slow-track licence drafting – Charge Restriction Conditions, 26 Sep 2014

Contents

Executive Summary

1.1. This document presents proposals that would enable SSEH to recover costs related to generating electricity to meet demand on Shetland. We believe these proposals will enable SSEH to fund the activities which relate to energy supply on Shetland while ensuring value for consumers' money. The policy and licence changes we would like to make are explained throughout. We also set out the updated cost forecasts which will be included in SSEH's financial model.

1.2. This document describes our proposed changes to the recovery arrangements for the Shetland Energy Costs. These are accompanied with updated cost forecasts. We present the Charge Restriction Condition (CRC) licence changes that we believe are necessary to bring SSEH's cost recovery arrangements in line with RIIO-ED1 and developments on Shetland. These CRC changes are accompanied with an explanation of the reasons behind these changes and the intended effects.

1.3. Our policy intent is to minimise the cost of the existing cross subsidy and ensure the security of supply on Shetland. Our proposals recognise the uncertainty of some Shetland costs, so we propose to continue the current mechanism and pass some costs through to consumers. We are proposing that all costs within the control of SSEH will be subject to the totex incentive mechanism. We have also set out arrangements for highly uncertain costs. Although the mechanisms have been amended, the recovered costs broadly remain the same as the current arrangements.

Next Steps

These are our draft proposals for consultation. We ask questions throughout this document on our proposals and welcome your views which we will consider when we make our final determination. Please send responses to rory.mccarthy@ofgem.gov.uk by 07 November 2014. We will publish our final determination on SSEH's Shetland Energy Costs in November 2014.

1. Introduction

Chapter Summary

Background to Shetland's energy supply arrangements, the purpose and structure of the document.

Background

1.1. Shetland is an islanded network, serving around 13,500 customers, with no electricity connection to the GB mainland. Scottish Hydro Electric Power Distribution (SSEH) owns and operates the distribution network that serves the Shetland Islands and operates as the Distribution System Operator (DSO) on the islands. SSEH is allowed to recover some of the costs of generating electricity to meet demand on Shetland from its customers on the mainland network.

1.2. There are two main generators on Shetland. Lerwick Power Station (LPS) is a 67 MW diesel fired power station owned by SSE generation which meets around 52 per cent of demand. In addition to this, a privately owned 100MW gas fired power station at the Sullom Voe Terminal, provides supply of up to 22MW and meets around 41 percent of demand. Wind farms on the island contribute the remainder.

Shetland's cross subsidy

1.3. Due to its isolated nature, electricity generation costs on Shetland are significantly higher than on the mainland. The Common Tariff Obligation (CTO) ensures that electricity suppliers maintain a common tariff within a given area of Scotland. The obligation was originally put in place by section 3(2)(a) of the Electricity Act 1989. As a consequence, the Secretary of State made an order in 1990 (The Electricity Act 1989 (North of Scotland Specified Area) Order 1990) designating Shetland as an area which would benefit from the CTO. Under the original enactment of the CTO and 1990 order, there was no restriction to its application and it therefore applied to both domestic and non-domestic consumers.

1.4. In order to facilitate the operation of these arrangements, we introduced Charge Restriction Condition (CRC) 4 into SSEH's licence for DPCR5. It allows for the costs of generation on Shetland to be recovered through SSEH's licence ie to be passed through to SSEH's customers (suppliers) via Distribution Use of System (DUoS) charges.

1.5. The effect of the CTO is to subsidise the higher costs of generation on Shetland across all of SSEH's customers. The value of the cross subsidy in 2013/14 was £26.6m. All of SSEH's customers across the North of Scotland have an additional £19 added to their annual bill as a result of the cross subsidy[3]. This cross subsidy arrangement will fall away in March 2015 at the end of the current price control period.

1.6. On 24 July 2014, DECC issued a consultation seeking views on the best way to continue to support the high generation costs for customers on Shetland.[3] In its consultation, DECC proposed to continue the cross-subsidy for existing non-domestic and domestic customers on Shetland. It proposed that the cross subsidy should also be continued for future non-domestic customers with a maximum demand connection up to 2MW. It also proposed that when the enduring energy solution for Shetland has been commissioned, the costs of the cross-subsidy will be recovered from all GB customers. Until then, costs will continue to be recovered from all SSEH customers.

1.7. Following this consultation, DECC will issue a direction on the future treatment of non-domestic customers on Shetland. Any necessary changes will be made to SSEH's Licence Conditions and charging arrangements following this policy decision.

1.8. The licence conditions proposed in this document would continue the cross subsidy arrangements to protect consumers from high prices, into the next price control period, RIIO-ED1.

Licence arrangements and other developments

1.9. At the time of the DPCR5 process, we recognised that LPS was reaching its end of life with increasing maintenance and environmental requirements. An obligation was placed in SSEH's DPCR5 licence (CRC18A) requiring it to propose a trial of innovative options (Shetland Trial) by 31 October 2011 and an enduring solution for Shetland (Integrated Plan for Shetland) by 31 July 2013. Alongside the integrated Plan, SSEH was required to propose a relevant Incentive Mechanism (IM) and a relevant adjustment (RA) to the CRCs in respect of the Shetland Integrated Plan costs.

1.10. In 2011 SSEH submitted a proposal for the Shetland Trial which we accepted.[4] The Shetland Trial, also known as the Northern Isles New Energy Solution (NINES) explores innovative solutions aimed at reducing maximum demand on Shetland, increasing renewable generation output and reducing the reliance on fossil fuels. The project received approval from Ofgem in November 2011 and funding of £15.33m.

1.11. On 31 July 2013, SSEH provided us with its proposed Integrated Plan to manage supply and demand on Shetland. In April 2014, we rejected this proposal. We decided to reject SSEH's IM because we were not persuaded that it adequately incentivises the efficient capital and operational costs of the Integrated Plan.

[3] Support for non-domestic electricity consumers on Shetland, DECC, 24 July 2014
[4] Decision on funding for the Shetlands Northern Isles New Energy Solutions (NINES) Project, 15 September 2011

1.12. Furthermore, we were not satisfied that SSEH had adequately tested the market for an enduring energy solution for Shetland and we were not persuaded that the costs of the plan were efficient. As such, in our decision letter[5] we determined that in order to be able to assess the IM and RA, we had to attach relevant conditions that the licensee must fulfil. These conditions were designed to ensure that a cost efficient energy solution for Shetland would be procured. This included requiring sufficient testing of the market through an open consultation and competitive process, overseen by an independent auditor. Ongoing cost efficiency would be ensured through an effective IM, to be submitted following the competitive process.

1.13. Interim energy arrangements are necessary to recover some of the costs of current generation on Shetland. This will ensure that generation will continue to meet demand and security of supply standards are maintained until the enduring energy solution is procured and commissioned. This is expected to be in 2019.

SSEH's 2014 Shetland costs submission

1.14. In August 2014, SSEH submitted to us its proposed interim energy arrangements, costs and amendments to the Charge Restriction Conditions (CRCs) associated with Shetland energy supply and developing an enduring energy solution for Shetland. This submission included operating plans for the interim period, evidence of past and future costs and cost forecasts for the interim period from 2014/15 to 2019/20.

1.15. These plans included a reference to amended operational procedures to extend the operating life of LPS, which generates the majority of electricity on Shetland. SSEH also stated that it would not be possible to run LPS beyond 2019/20, so the enduring solution needs to be in place by then.

Changes to cost recovery arrangements

1.16. SSEH currently recovers the Shetland Energy Costs according to a mechanism in its licence. This is mainly a pass-through mechanism, currently listed under CRC4, which allows SSEH to pass the Shetland Energy Costs through to its customers. Under this mechanism, there is no incentive to reduce costs. We consider that costs recovered under such mechanisms should be uncertain, and not be in the company's direct control.

1.17. We have commissioned an independent assessment of SSEH's August 2014 submission. We have also carried out our own cost assessment of the submission and developed a better understanding of Shetland's cost activities.

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[5] Ofgem's determination of Scottish Hydro Electric Power Distribution plc's (SHEPD) submission required under Charge Restriction Condition (CRC) 18A, 22 April 2014

1.18. We consider that cost recovery arrangements that relate to Shetland should be continued for the interim period until an enduring energy solution is established on Shetland. However, we think that changes to Shetland's recovery arrangements are necessary to ensure the costs of the cross subsidy are minimised whilst maintaining security of supply on Shetland.

Purpose of this document

1.19. In this document, we propose policy and associated licence changes that relate to the Shetland Energy Costs. We explain our proposed changes to the cost recovery arrangements that relate to Shetland. Then we provide an overview of the proposed CRC changes we would like to make. Questions are asked throughout.

1.20. The proposed CRCs are set out in 'Supplementary Annex 1: Draft CRC licence changes for SSEH's Shetland Energy Costs'.

1.21. This consultation seeks your views on whether our proposed cost recovery arrangements and licence drafting reflect the most efficient approach to recovering Shetland's costs. We welcome comments on the proposed drafting and the specific questions in this consultation.

1.22. This consultation runs alongside our consultation on the draft licence conditions (CRCs) that will apply to all DNOs for RIIO-ED1[6]. As we stated in that consultation, we are addressing DNO specific licence conditions separately.

1.23. After this consultation, we will publish our final determination on SSEH's Shetland Energy Costs in November 2014. Then we will include the proposed changes in our Statutory Consultation in December 2014. We aim to publish our final decision on the required licence modifications in February 2015. These will bring the relevant licence conditions (CRCs) into force from 1 April 2015.

Structure of this document

1.24. This document is structured as follows:

- Chapter 3 outlines the proposed changes to the cost recovery arrangements.
- Chapter 4 details the proposed changes to the CRCs, the reason behind the changes and the intended effect.
- Chapter 5 outlines the proposed changes to the Financial Handbook.

[6] RIIO-ED1: Informal consultation on slow-track licence drafting – Charge Restriction Conditions, 26 Sep 2014

2. Proposed cost recovery arrangements

Chapter Summary

We set out and explain the reasons behind our proposed changes to SSEH's cost recovery arrangements that relate to the Shetland Energy Costs.

Question 1: Do you have any views on the proposed pass-through items?
Question 2: Do you have any views on the proposed costs being subject to the totex incentive mechanism?
Question 3: Do you have any views on the proposed arrangements for the recovery of uncertain costs?
Question 4: Do you think SSEH's proposal for the recovery of Uncertain Shetland Interim Costs should be from 1 May 2016 – 31 May 2016 or from 1 May 2017 – 31 May 2017?
Question 5: Do you think SSEH's proposal for the recovery of Uncertain Competitive Process and Integrated Plan Costs should be from 1 May 2016 – 31 May 2016 or from 1 May 2017 – 31 May 2017?
Question 6: Do you have any views on the level of the proposed costs?

2.1. We describe the purpose of each cost item, the proposed policy and licence provisions required. These cost items are all related to the Shetland Energy Costs. The cost items appear in the order of the CRCs in the licence (see Supplementary Annex 1). The proposed costs are also presented.

2.2. Where we refer to the 'current' condition, or what a condition 'currently' refers to, we are referring to the condition in the current (DPCR5) licence.

2.3. All costs presented in this chapter are in 2012/13 prices unless stated otherwise.

2.4. The proposed cost recovery arrangements are summarised in the table below:

Mechanism	Item	Description
Pass through	SEC_t – Shetland Energy Costs	Made up of LPS fuel costs plus the cost of Environmental Permits minus income from units purchased by suppliers.
	NINES – Northern Isles New Energy Solutions	The remaining allowance for the Shetland Trial (NINES).
Subject to the totex incentive mechanism	SFE – Shetland Fixed Energy Costs	Made up of the costs of third party contracts

	Allowance	(Power Purchase Agreements (PPAs)) plus contingency costs (if applicable) plus LPS capital and operating costs.
	CPC - Competitive Process and Integrated Plan Costs	The costs of developing the Integrated Plan and running the competitive process.
2.5. Arrangements for the recovery of uncertain costs	UCSIC – Uncertain Shetland Interim Costs	Potential uncertain cost of supplying energy on Shetland
	UCCPC – Uncertain Competitive Process and Integrated Plan Costs	The potential uncertain costs related to running the competitive process and uncertain internal and related party staff costs of developing the Integrated Plan and running the competitive process.

Pass-through items

2.6. These cost items will be recovered on a pass-through basis and subject to a two-year lag. Pass-through items relate to uncertain costs which are not in SSEH's direct control, so it is reasonable and fair that they are passed through to its customers. In the proposed licence, the pass-through items are listed under CRC2P Calculation of Shetland Energy Costs.

2.7. These reflect pass-through costs related to the interim energy arrangements for Shetland. The interim arrangements will be in place until the enduring energy solution for Shetland is commissioned which is currently assumed to be 2019. Changes are also required to bring the condition in line with the RIIO licence format and arrangements.

2.8. Under CRC2P Calculation of Shetland Energy Costs we propose to set an ex ante allowance for each of the pass-through items which will be used in the RIIO-ED1 Financial Model to set the Base Demand Revenue. This allowance will then be trued up, with a two year lag for actual costs to reflect the Authority's decision on measures to mitigate charging volatility.[7]

SEC_t – Shetland Energy Costs

Definition: means the amount representing part of the cost of energy supply on Shetland which will be recovered on a pass-through basis in Regulatory Year t.
Change: some items have been moved to other conditions in the licence, the remaining items continue as pass-through, and subjected to a two year lag.
Current Term: MPA_t

2.9. These changes reflect developments described in this consultation document and enable some Shetland cost items to continue to be recovered on a pass-through basis in CRC2P (Shetland Energy Costs Pass-Through Items). The Calculation of Shetland Energy Costs term is being changed from:

$$MPA_t = TPC_t + LPSF_t + LPSC_t + EP_t - SH_t - SHB_t$$

to:

$$SEC_t = LPSF_t + EP_t - SH_t$$

$LPSF_t$ - Lerwick Power Station Fuel Costs

Definition: means the amount representing the cost of fuel purchased for use by Lerwick Power Station (LPS) in Regulatory Year t.
Change: remain as a pass-through term but subject to a two year lag.
Current Term: $LPSF_t$

2.10. Fuel costs are not in direct control of SSEH but are reliant on electricity demand on Shetland and market prices that are subject to uncertainty and volatility. As such this will be recovered on a pass-through basis, subject to Agreed Upon Procedures (AUPs).

2.11. The costs forecast below will be included in the forecasts used to set the SEC term in the RIIO-ED1 Financial Model.

Forecast costs (£m)

	2014/15	2015/16	2016/17	2017/18	2018/19
Costs (£m)	14.09	14.09	14.09	15.23	15.55

[7] Decision in relation to measures to mitigate network charging volatility arising from the price control settlement, October 2012

EP_t - Environmental Permits

Definition: means the cost of environmental permits in respect of generation on Shetland in Regulatory Year t.
Change: remains as a pass-through term but subject to a two year lag.
Current Term: EP_t

2.12. Environmental Permits, which mainly include EU Emission Trading Scheme (ETS) credits and Carbon Price Floor (CPS) Tax, are required for running LPS and are not in the control of SSEH so remain as pass-through, subject to AUPs.

2.13. The forecast costs presented below will be used to calculate the SEC term.

Forecast costs (£m)

	2014/ 15	2015/ 16	2016/ 17	2017/ 18	2018/ 19
Costs (£m)	0.50	0.37	0.40	0.65	0.71

SH_t – Supplier Purchase Income

Definition: means the income from units purchased by suppliers in respect of generation on Shetland for Regulatory Year t.
Change: subject to a two year lag.
Current Term: SH_t

2.14. All output from LPS and the power supplied by SVT is purchased by SSE Energy Supply Limited at an agreed power exchange market rate. This is deducted from the Shetland Energy Costs to determine SSEH's remaining recoverable allowance. This mechanism will continue for the interim period, subject to AUPs. The forecast amount is presented below. The figures presented below use the actual costs for SH_t from 2013/14 and repeat these for the remaining interim years (presented in 2012/13 prices).

Forecast costs (£m)

	2014/ 15	2015/ 16	2016/ 17	2017/ 18	2018/ 19
Costs (£m)	9.83	9.83	9.83	9.83	9.83

NINES – Northern Isles New Energy Solutions

Definition: means the cost incurred by SSEH in Regulatory Year t associated with running the trial of innovative options (the "Shetland Trial") to manage the supply

and demand of electricity on Shetland as set out in our decision letter[4]. Ongoing NINES costs which will be recovered as part of the enduring solution costs.
Change: Not applicable
Current Term: recovered under UNC_t

2.15. In our Funding Determination letter in 2011 we agreed to fund an allowance for the "Shetland Trial" of £15.33m (2010/11 prices). Over DPCR5 a portion of this allowance has been recovered, totalling £5.52m (2012/13 prices). We propose to fund the outstanding allowance for NINES in ED1.

2.16. The funding for NINES will continue through adjustments to the UNC_t term which will be pass through, until the enduring energy solution is commissioned. The numbers below are presented in 2012/13 prices

Forecast costs (£m)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/219
Costs (£m)	4.36	1.16	2.21	2.21	2.21	2.21	2.21

Items subject to the totex incentive mechanism

2.17. The following items can be forecast with some certainty and are in SSEH's direct control. Therefore we propose that they are given a fixed allowance value and subject to the totex incentive mechanism to ensure only efficient costs are passed on to customers.

2.18. The totex incentive mechanism ensures efficiency of the costs as set out in our strategy decision.[8] SSEH will share, with its customers, any reward if it achieves costs that are more efficient than those included in its allowance. It will also share, with its customers, any penalty if it achieves costs that are less efficient than those included in its allowance.

SFE – Shetland Fixed Energy Costs Allowance

Definition: means the amount of the Shetland Fixed Energy Costs Allowance assumed in setting Base Demand Revenue (Restriction of Distribution Charges: Use of System Charges) for third party contracts, contingency costs (if applicable) and LPS capital and operating costs.

[8] Strategy decision for the RIIO-ED1 electricity distribution price control Outputs, incentives and innovation. 26a/13. 04 March 2013.

Change: new single fixed cost item subject to the totex incentive mechanism.
Current Term: SHB_t

2.19. Under this proposal, the SFE allowance will be the amount representing the annual cost of contracts with third party generators for supplying customers on Shetland (currently TPC_t), plus contingency costs (if applicable), plus the amount representing the capital and operating costs incurred in relation to LPS (currently $LPSC_t$) (excluding costs associated with the terms LPSF and EP, which are explained above). TPC_t and $LPSC_t$ will now be defined under the SFE allowance.

2.20. Third party contract costs cover the cost of the Power Purchase Agreement (PPA) between SSEH and SVT, necessary to balance generation and supply on Shetland. These costs are somewhat driven by demand and system dynamics, but they are also subject to negotiated contracts with SVT. This means that SSEH can influence the value of these contracts. Contingency costs and LPS capital and operating costs are also in SSEH's direct control. Therefore we propose that SFE will be given a fixed allowance and subject to the totex incentive mechanism. SFE will also act as the opening allowance for the Uncertain Shetland Interim Costs (see paragraphs 2.26 to 2.31) in case material costs arise during the interim period from the cost activities described here.

Forecast costs (£m)

	2014/15	2015/16	2016/17	2017/18	2018/19
Costs (£m)	19.54	20.19	20.39	20.38	21.14

CPC - Competitive Process and Integrated Plan Costs

Definition: means the cost incurred by SSEH in Regulatory Year t associated with the development of the proposed Integrated Plan submitted on July 31 2013, appointing an independent auditor, conducting a public consultation and running a competitive process to identify and implement an enduring solution as set out in our decision under CRC18A[9] (proposed to be CRC2Q). The opening value excludes staff costs internal to SSEH and costs of related parties, including affiliates and related undertakings of the licensee as defined in standard licence condition 1.
Change: new fixed cost item subject to the totex incentive mechanism.
Current Term: Not applicable

2.21. These costs relate to conditions imposed on SSEH by us to develop an Integrated Plan, and decisions made under CRC18A to ensure the market is

[9] Ofgem's determination of Scottish Hydro Electric Power Distribution plc's (SHEPD) submission required under Charge Restriction Condition (CRC) 18A, 22 April 2014

adequately tested for the most cost efficient energy solution for Shetland by running a competitive process. The integrated plan development was a requirement of CRC18A, which required SSEH to propose an enduring energy solution for Shetland. The development costs included work on the identification of supply and demand options, and their analysis. The competitive process is required to find an enduring solution for Shetland as set out in our decision letter.[5] We assessed the costs for both activities, and propose to fix a portion of these costs and subject this to the totex incentive mechanism.

2.22. We cannot approve internal SEEH and related party staff costs at this time. A related party includes both affiliates and related undertakings of the licensee as defined in standard licence condition 1. Internal costs and related party costs have not been fully evidenced and justified and require further assessment. We require additional evidence that internal costs are not already covered by RIIO-ED1 allowances and duplicated. Some of the projected costs related to the competitive process are also uncertain. Therefore these costs will be subject to arrangements for uncertain costs in CRC 3F. We would envisage that this approach should deliver efficient costs throughout the process.

2.23. We therefore propose to fix a portion of the costs and subject this to the totex incentive mechanism. These costs occur from 2011/12 to 2015/16 and the recoverable allowance is presented in the table below. We propose that CPC will also act as the opening allowance for the Uncertain Competitive Process and Integrated Plan Costs (see paragraphs 2.32 to 2.33).

<u>Forecast costs (£m)</u>

	2014/15	2015/16	2016/17	2017/18	2018/19
Costs (£m)	-	2.61	-	-	-

Arrangements for the recovery of uncertain costs

2.24. Cost items which fall under this category have a high degree of uncertainty, and currently cannot be forecast reliably. A mechanism (CRC 3F Arrangements for the recovery of uncertain costs) has been established to allow a licensee's opening levels of allowance to be revised for these uncertain cost activities.

2.25. The uncertainty mechanism in respect of the Shetland Interim Costs and the Competitive Process and Integrated Plan Costs is symmetric and can be opened for either an upward adjustment, as proposed by the licensee, or downward adjustment, as proposed by the authority. The symmetric uncertainty mechanism has a materiality threshold which is equal to 20% of the opening ex ante allowance.

UCSIC - Uncertain Shetland Interim Costs

Definition: means potential uncertain cost of supplying energy on Shetland incurred, or expected to be incurred by SSEH during the interim period between 1 April 2015 and the new enduring solution for managing supply and demand on Shetland comes into effect, but only to the extent that these costs are not recoverable under any other part of this licence.
Change: new item which will be treated as an uncertain cost item
Current Term: non-applicable

2.26. Since our decision letter in April 2014, a cost recovery proposal has been developed by SSEH for the interim energy arrangements on Shetland until the enduring solution is in place. This was submitted to us in August 2014. This included various cost items and arrangements to support a new running profile for LPS needed to extend its asset life until the enduring energy solution is in place. This included contingency arrangements which involved installing temporary mobile generation units to offset the reduced running of LPS's engines. We appointed third party consultants to assist us with our assessment of these cost recovery arrangements from a financial, technical, customer impact and safety perspective.

2.27. The consultants' analysis concluded that, although SSEH's proposed measures would reduce the risk of failure and would have a positive effect on the running life of LPS, the evidence provided failed to show that the proposal delivered the most cost efficient solution for SSEH's customers. This is particularly important if they are to bear the burden of the subsidised costs. In particular, some of the cost estimates did not have appropriate system studies or involve any option analysis.

2.28. We also concluded that, at present, some additional cost items, particularly in relation to the new running profile for LPS, are highly uncertain. We accept that there may be changes in costs or, for example, from changes to PPA costs, contingency arrangements and environmental upgrades. For instance, as per SSEH's submission, if contingency arrangements replace third party contract PPAs, this may result in lower overall costs. The consultants' analysis also suggests that the proposed contingency costs could be reduced by a further, material amount.

2.29. We propose to fix costs for third party contracts, contingency costs (if applicable) and LPS capital and operating costs, and recover these under the SFE allowance. In the event that other costs materialise from, for example, environmental upgrades, or the SFE costs increase by a material amount, we propose to have an arrangement for the approval and recovery of uncertain Shetland Interim Costs. This arrangement will also come into effect if SFE costs decrease by a material amount.

2.30. The opening allowance for Shetland Interim Costs will be set at the total fixed costs for Shetland (SFE) described in paragraphs 2.19 to 2.20. If SSEH faces material cost changes, in relation to its SFE allowance (CRC 2P and CRC 2Q), it can propose the recovery of these additional costs. This proposal can be made to us between [1 May 2016 or 1 May 2017] and [31 May 2016 or 31 May 2017]. Actual dates depend on our post-consultation decision.

2.31. This proposal will go through our methodology for determining the recovery of uncertain costs as set out in the ED1 Price Control Financial Handbook draft in Supplementary Annex 2. This proposal can then be confirmed, rejected or amended.

UCCPC – Uncertain Competitive Process and Integrated Plan Costs

Definition: means potential uncertain costs related to meeting the conditions of the Authority's decision under CRC2Q, including potential uncertain internal staff costs and costs of staff from related parties including affiliates and related undertakings of the licensee as defined in standard licence condition 1, associated with the development of the Integrated Plan submitted in accordance with CRC2Q and meeting the conditions of the Authority's decision under CRC2Q.
Change: new item which will be treated as an uncertain cost item
Current Term: non-applicable

2.32. In SSEH's submission, we received estimated costs for the integrated plan development and estimates for costs to run the competitive process to find an enduring solution for Shetland. As stated in paragraphs 2.21 to 2.23, at this point the relevant internal and related party costs have not been fully evidenced and justified, but we will fix external costs related to these activities. Some of the projected costs that relate to the competitive process are uncertain.

2.33. The opening allowance for Uncertain Competitive Process and Integrated Plan Costs will be set at the fixed costs for CPC. If SSEH faces material cost changes in relation to its fixed allowance for CPC including internal staff costs and costs of staff from related parties, it can propose the recovery of additional costs through the uncertainty mechanism as described in paragraph 2.31. This arrangement will also be triggered if CPC costs decrease by a material amount. This proposal can be made to us between [1 May 2016 or 1 May 2017] and [31 May 2016 or 31 May 2017]. Actual dates depend on our post-consultation decision.

3. CRC licence changes

Chapter Summary

We set out our proposed changes to the CRCs for SSEH in relation to Shetland's energy supply costs.

Question 1: Do you have any views on the proposed CRCs?
Question 2: Do you have any views on the reasons and effects for the proposed licence changes?
Question 3: Do you have any views on the proposed cost recovery arrangements and the proposed level of the costs?

Reasons and effects for proposed CRC changes

3.1. We have set out the reasons and effects for the proposed CRC amendments in the order they appear in the new structure of the CRCs in the SSEH RIIO-ED1 licence (see Supplementary Annex 1).

3.2. We are seeking views on the proposed CRC amendments and the reasons and effects for:

- Proposed changes to the Calculation of Allowed Pass-Through Items, to update some of the references to align with other changes.
- Proposed changes to CRC2N Assistance for high-cost distribution areas for SSEH.
- Proposed changes relating to the Calculation of Shetland Energy Costs, to bring the condition in line with the proposed cost recovery arrangements.
- Proposed consequential changes to the arrangements for the recovery of costs for an integrated plan to manage supply and demand on Shetland.
- Proposed changes to the arrangements for the recovery of uncertain costs, and adding an uncertain cost item relating to Shetland Interim Costs.

Chapter 2 changes

CRC 2B. Calculation of Allowed Pass-Through Items

Type of change: Amendment
Current number: CRC 4
Current name: Restriction of Distribution Charges: calculation of the Allowed Pass-Through Items

3.3. The purpose of this condition is to calculate the pass-through costs that the licensee is allowed to recover from customers.

3.4. There are no significant changes to the broad intent of the current condition. The two year lag has been added for SEC to make it consistent with our strategy decision on mitigating volatility for ED1. We have also changed references to keep them in line with other condition references detailed below:

- The acronym MPA has been changed to SEC (Shetland Energy Costs)

CRC 2N. Assistance for high-cost distribution areas for SSEH

Type of change: Amendment
Current number: CRC 17
Current name: Assistance for high-cost distribution areas

3.5. The condition sets out the obligations of the licensee in relation to annual payments received for the purpose of providing assistance with the high costs of distributing electricity in specific areas. The reason for the change is to ensure that the condition fits within the structure of the RIIO-ED1 licence structure.

3.6. There are no significant changes to the intent of the existing condition. The effect of the modification is to renumber the condition to CRC2N, update its cross references and to amend its title to clarify which licensee it applies to.

CRC2P. Calculation of Shetland Energy Costs

Type of change: Amendment
Current number: CRC 4 Appendix 3
Current name: Calculation of Shetland balancing costs

3.7. These changes reflect developments that relate to uncertain Shetland Energy Costs described previously in this document.

3.8. This update replaces Appendix 3 of CRC4. The effect of these changes is to:

- Make the appendix a stand-alone condition, numbered as CRC 2P.
- Include cost items which are required during the interim period.
- Update the cost forecasts.
- Redefined SHB_t as SFE (fixed items) and subject to the totex incentive mechanism.
- Introduce a two year lag to the adjustments to mitigate charging volatility.
- Continue Agreed Upon Procedures (AUPs) review requirements for certain pass-through items.
- Define Shetland's fixed cost items which are subject to the totex incentive mechanism

CRC 2Q. Arrangements for the recovery of costs for an integrated plan to manage supply and demand on Shetland

Type of change: Amendment to existing CRC
Current number: CRC 18A
Current name: Arrangements for the recovery of costs for an integrated plan to manage supply and demand on Shetland

3.9. The reason for updating this condition is to reflect changes in the relevant condition's titles.

3.10. The effect of this amendment:

- Renumbers the condition as CRC 2Q.
- Amends references in the relevant adjustment section to account for the additional uncertain cost activity added to CRC 3F.
- Updates some of the references to be consistent with other condition title changes.

Chapter 3 changes

CRC 3F. Arrangements for the recovery of uncertain costs

Type of change: Amendment to existing CRC
Current number: CRC 18 (excluding Part E)
Current name: Arrangements for the recovery of uncertain costs

3.11. The reason this condition has been amended is to allow for the recovery of costs for Shetland that are considered uncertain at the time of setting the price control.

3.12. We propose to add an uncertain cost item to this condition which relates to potentially uncertain interim energy costs on Shetland (UCSIC). This cost item will be given a PCFM variable value name and enables the opening levels of allowed expenditure related to fixed costs for Shetland to be revised. The details of this cost item are described in the previous chapter and are included in the licence drafting in Supplementary annex 1. The Financial handbook has also been amended to take account of these changes which can be found in Supplementary Annex 2.

4. Financial Handbook Changes

4.1. The Financial Handbook details the methodology of submitting and reviewing the uncertain Shetland Interim Costs (UCSIC) and the Uncertain Competitive Process and Integrated Plan Costs (UCCPC). Chapter 7 of the handbook should be read alongside CRC3F to ascertain the mechanisms of the uncertain costs. The handbook prescribes the general principles applicable to uncertain costs and the process by which the Authority determines a relevant adjustment proposed by the licensee.

4.2. The proposed Financial Handbook draft changes can been found in Supplementary Annex 2.

Appendices

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Appendix 1 - Consultation Response and Questions

1.1. We would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

CHAPTER: Three
Question 1: Do you have any views on the proposed pass-through items?
Question 2: Do you have any views on the proposed costs being subject to the totex incentive mechanism?
Question 3: Do you have any views on the proposed arrangements for the recovery of uncertain costs?
Question 4: Do you think SSEH's proposal for the recovery of Uncertain Shetland Interim Costs should be from 1 May 2016 – 31 May 2016 or from 1 May 2017 – 31 May 2017?
Question 5: Do you think SSEH's proposal for the recovery of Uncertain Competitive Process and Integrated Plan Costs should be from 1 May 2016 – 31 May 2016 or from 1 May 2017 – 31 May 2017?
Question 6: Do you have any views on the level of the proposed costs?

CHAPTER: Four
Question 1: Do you have any views on the proposed CRCs?
Question 2: Do you have any views on the reasons and effects for the proposed licence changes?
Question 3: Do you have any views on the proposed cost recovery arrangements and the proposed level of the costs?

1.3. Responses should be received by 6 November 2014 and should be sent to:

- Rory McCarthy, Senior Policy Analyst
- Distribution Policy
- Ofgem, 9 Millbank, London, SW1P 3GE
- 020 3263 9684
- rory.mccarthy@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish our final determination on SSEH's Shetland Energy Costs in November 2014.

1.7. Any questions on this document should, in the first instance, be directed to:

- Rory McCarthy, Senior Policy Analyst
- Distribution Policy
- Ofgem, 9 Millbank, London, SW1P 3GE
- 020 3263 9684
- rory.mccarthy@ofgem.gov.uk

Appendix 2 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk