Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ

Mark Copley
Transmission Policy Manager
Ofgem
9 Millbank
London
SW1P 3GE

Tel: 01738 456400
Fax: 01738 456415

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Dear Mark,

Access Reform in Electricity Transmission – Working Group Report

Our response to the report by the Access Reform Options Development Group is enclosed.

If you have any questions or require any further information, please give me a call.

Yours sincerely

Rob McDonald
Director of Regulation

Access Reform Options Development Group

SSE Response

Introduction

In general, we believe a review of transmission access is required to facilitate competition in generation and, in particular, to ensure proportionate arrangements of underwriting of investment.

Although Ofgem has stated that the purpose of the report is to help parties develop specific proposals for change, we believe that Ofgem continues to have an important role to play in facilitating access reform – not least because of the potential interactions with the ongoing transmission price control review (TPCR). It is our view that changes to the access arrangements cannot be made in isolation, and that proposed changes must be mindful of the outcome of the ongoing price review. Further, we believe that Ofgem's preferred option of revenue drivers for load related capital expenditure has significant implications for the security that is required from new users of the transmission system. It is therefore vital that any reforms to the access arrangements are made in tandem with the new price control from 1 April 2007.

The current arrangements for underwriting investment in transmission capacity using Final Sums Liability ("FSL") provisions are designed to ensure that the generality of customers are fully protected from funding unnecessary transmission capacity caused by a user terminating a project before commissioning. Any change to the FSL arrangements is likely to transfer an element of risk onto transmission licensees and/or customers. This being the case, Ofgem would need to approve any revised underwriting arrangements so that transmission licensees can be sure that any efficient investment not otherwise recovered through the new underwriting arrangements could be recovered through use of system charges.

In our response to the report of the access reform working group, we consider four issues:

- The need for user commitment;
- The financial security required from new users prior to physical connection to the transmission system;
- The access rights of new users following physical connection to the transmission system, but before the granting of Transmission Entry Capacity (TEC); and

- The provision of unrestricted access (TEC).

Our comments on each of these areas are set out below giving due consideration to the ongoing TPCR.

User commitment

We believe that user commitment is an essential element of any change to the access arrangements. In its simplest form, user commitment is a mechanism whereby generators commit to connecting to the transmission system and, in return, the transmission licensees commit to providing the user with TEC. By entering into commitments, both the user and the transmission licensee are provided with greater certainty and risks are, in our opinion, more fairly allocated.

In this response we consider:

- Who should be required to commit?
- When should users be required to commit?
- What should users be required to commit to?
- What are the obligations placed on the transmission licensee when a user commits?

In the report of the access reform working group, a number of options are considered for the who, when and what of user commitment. It is suggested that both new users and existing users could be required to provide user commitment. The report considers that the most appropriate form of user commitment would be a commitment to pay for TEC at the prevailing level of charges for a fixed period following the completion of local infrastructure assets.

We do not believe that user commitment can, in practise, be applied retrospectively to existing users of the transmission system. Further, we do not consider that such a commitment would benefit either the existing user or the transmission licensee. From the perspective of the transmission licensee, it is unlikely that this would aid network investment decisions. Consequently, we believe that user commitment should only be required from new users.

In principle, we accept that a commitment to pay for TEC for a fixed number of years is the most appropriate form of user commitment for new users. We remain concerned, however, about the TNUoS charging methodology and, in particular, the lack of transparency and volatility of the model. We do not believe that it would be appropriate to require new users to commit under the

current unstable charging regime. Further, it is not clear how user commitment could be implemented in the negative TNUoS charging zones.

These issues need to be resolved before moving to a user commitment model based on TNUoS charges. In the first instance, this will require NGET to undertake the thorough review of TNUoS charges that was a prerequisite of the approval of its charging methodology for BETTA. Second, the new user commitment should be fixed at the prevailing TNUoS charge for the zone at the time of commitment, multiplied by three (or however many years the user commitment will apply for). In particular, it would be unreasonable to require users to pay at commitment a charge equal to the *actual* TNUoS prevailing in the next three years, since these charges will not be known at the time the contract is made. Finally, we consider that five years is excessive and a three year commitment would be sufficient and proportionate.

The timing of an individual user's commitment should, we believe, recognise the risk profile of that user's development. It is not, in our opinion, appropriate to require a user to provide commitment until such time as that user can be certain that the progression of their scheme is largely within their control. We believe that a user has that certainty following the granting of consents and that user commitment should be required between the granting of consents and the beginning of construction of local infrastructure assets. Users should also have the option to commit earlier.

As described above, user commitment is a signal to transmission licensees that a new development will proceed to connection. Once a user has made this commitment it is appropriate that the transmission licensee responds with a commitment to grant TEC to that user by a specified date. We consider the timing of the transmission licensee's commitment in more detail below.

In summary, we strongly support the proposal for user commitment. We believe that this should be required from all new users, but not be required from existing users of the transmission network. The most appropriate form of user commitment is, in our opinion, a commitment to pay for TEC for a fixed period of three years. We remain concerned, however, whether this could be implemented using the current TNUoS charging methodology. Users should be obliged to commit subsequent to the granting of consents but before construction of local infrastructure assets begins, with that commitment taking effect from the granting of TEC or the date of withdrawal. A key element of the user commitment should be a commitment from the transmission licensee to a date for the granting of TEC. We also believe that NGET should, as a matter of urgency, complete the fundamental review of its TNUoS charging methodology that was a requirement of BETTA approval.

Security prior to CEC

The role of network companies is to provide a local connection to the network and to undertake any deeper system reinforcements required to ensure compliance with the relevant standards. Under the current arrangements, a new generator is required to provide financial security against both local and deep system works. That security falls away when the user connects, and the transmission licensee recovers the cost of the new assets through a return on its RAV.

In its third consultation on the TPCR, Ofgem indicated that its preferred option is to develop locational revenue drivers for investment in new network capacity. This would be a major change to the current mechanism for providing a revenue allowance for load related capital expenditure and has significant implications for access arrangements, specifically, the underwriting requirements on new generators. We believe that changes to access arrangements can only be made in the context of the TPCR settlement.

We recognise four components to the physical connection of a new generator: (i) new local sole use infrastructure; (ii) new local shared use infrastructure; (iii) pre-construction work for deep system reinforcements; and (iv) construction of deep system reinforcements. Our comments on the underwriting requirements for each of these components are set out below. These issues are discussed in the context of the TPCR proposals for funding load related capital expenditure. We believe that island links raise separate underwriting issues, and we consider the issue of access arrangements for new users on islands later in this response.

Local infrastructure

For a new generator to connect to the national transmission network, new assets will have to be constructed. Under the existing arrangements, the new user provides financial security against the cost of the new local infrastructure under the FSL methodology. As this investment is solely for the benefit of the new generator then it is, in our opinion, appropriate that the new generator is liable. Consequently, we believe that the existing FSL provisions to underwrite investment should continue to be applied for the new local assets required to connect to the existing infrastructure. This includes sole use assets and any shared use assets.

The first category of new local assets is sole use infrastructure. As sole use assets are identifiable against the user, we believe the existing FSL arrangements should apply in full to these assets. That is, the developer will continue to be required to provide full financial security against this investment.

The second category of new local assets is shared use infrastructure. These assets are shared with other new users as the most efficient means of connecting a number of new generators to the existing transmission network. Under the current arrangements, the FSL for shared use assets can be large and volatile. We believe that a developer's liability for shared use assets should be fixed at the time of the connection offer. This would mean that one developer would not be affected by the choices of other developers that share new infrastructure. For example, if a user is deemed liable for 20% of an asset shared by three other developers then that user would remain liable for 20% even if one, two or all three of the other developers withdrew. The transfer of risk to the transmission licensees would, however, require an approval from Ofgem would that all efficient investment undertaken in good faith can be recovered through the RAV.

Under the current arrangement, new users are exposed to FSL until they are granted TEC. Should Ofgem introduce a revenue driver for local infrastructure, we believe that the duration of FSL will need to be reviewed. It would not be appropriate for new users to continue to underwrite an asset for which, through a revenue driver, the transmission licensee receives a revenue stream. This could, of course, mean no change if the revenue driver is triggered by the granting of TEC. Alternatively, this could remove the need for FSL if the revenue driver is triggered when costs are first incurred.

In our opinion, an appropriate trigger for a revenue driver for local infrastructure would be when the user commits. At this time, as described above, there would be sufficient certainty that the new generator would proceed to connection and the transmission licensee could proceed with construction of the asset with certainty that it was an efficient investment.

In summary, for local sole use and shared use investment, we believe that a new generator's FSL should comprise:

- Full financial security against the cost of sole use assets; and
- A fixed sum to provide security against the cost of shared use assets.

This is illustrated graphically in Figure 1 below.

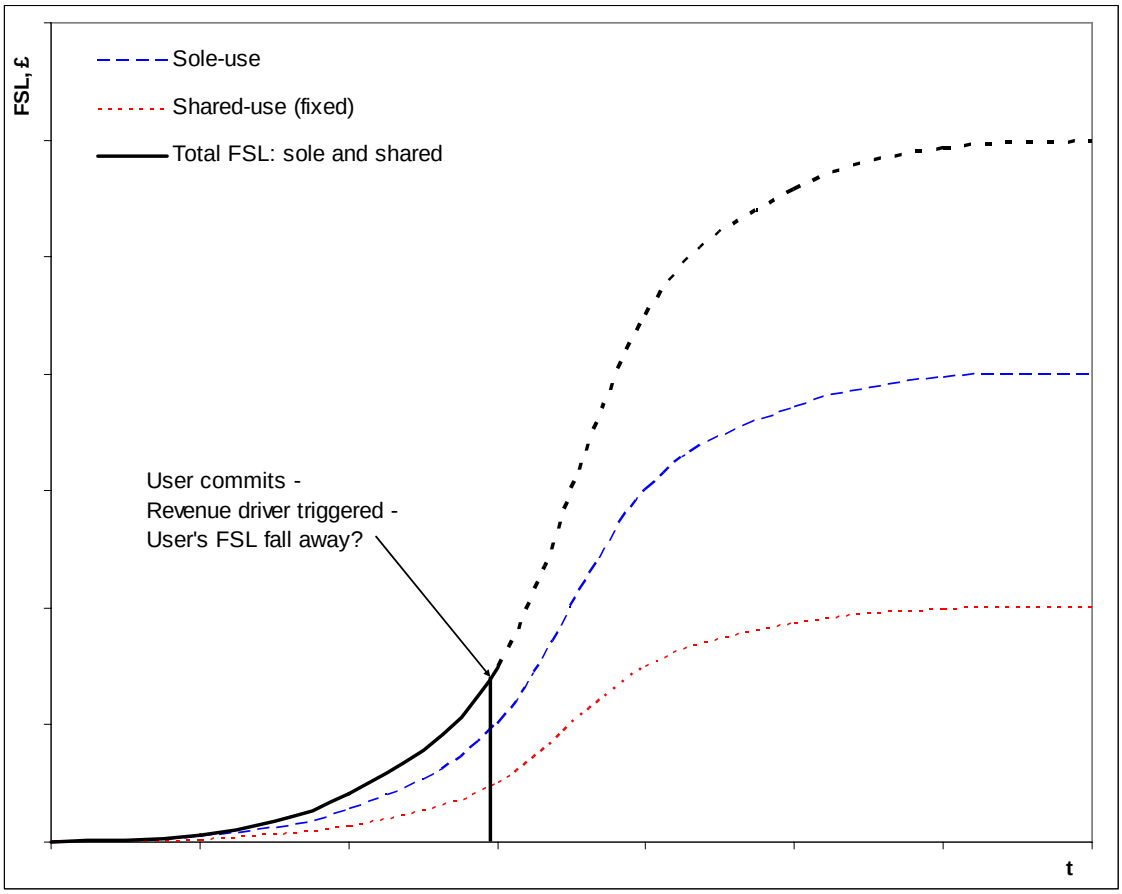

Figure 1 Proposed FSL for new local infrastructure for new generator

We believe that the existing FSL methodology is appropriate for determining liability for sole use infrastructure investment and the total liability for shared use infrastructure investment. A new methodology would be required to determine each user's fixed share of the liability for shared use assets. Should a revenue driver mechanism be introduced, a new user's exposure to FSL should be linked to the trigger for that driver. We believe that the revenue driver should be triggered when a user commits and, in these circumstances, no further FSL would be required. Otherwise, if the revenue driver is triggered when a user connects, FSL will be required and there will be a funding gap between the licensee incurring expenditure and receiving revenue. This would need to be taken into account in setting the revenue driver.

Reinforcement of the main transmission system

For deep system reinforcements, the link between the new generator and the investment is more tenuous. Deep system reinforcements are typically high

cost and take many years to achieve. Consequently, we do not believe that it is right that new users bear full financial liability for these works.

The first stage in reinforcing the main transmission system is the pre-construction phase. This includes planning and design, environmental impact assessments and the application for consents. The second stage in reinforcing the main transmission system is the construction. As with investment in local infrastructure, expenditure on pre-construction and construction of reinforcements to the transmission system are linked to decisions made in the TPCR on funding mechanisms, specifically Ofgem's preference for revenue drivers.

We have advocated that the pre-construction phase of deep system reinforcements should be funded through an ex-ante allowance (i.e. as per the "normal" method for allowing capex in setting price controls) subject to a pre-defined trigger as described below. We believe that it would be possible to set such an ex-ante allowance because the amount of anticipated expenditure on pre-construction works is unlikely to vary significantly. We also do not see how a revenue driver could be set to recover these effectively fixed costs. Should Ofgem accept an ex-ante allowance, and accept that pre-construction expenditure is incurred efficiently, then there would be no need to underwrite this expenditure.

If not, then we believe that it is right that new users should be financially liable for the pre-construction costs incurred by the transmission licensees recognising that the scheme may not proceed to construction if the developers withdraw. Such underwriting would be of particular importance should Ofgem choose a revenue driver mechanism that is only triggered during the construction phase (although it should be noted that we would find such a mechanism unacceptable).

In order to ensure that pre-construction works are commenced at an appropriate time, there needs to be a trigger point. This would apply to either an ex-ante allowance or underwriting by new users. A clear trigger point would also provide certainty to new generators about the progress of system reinforcements and the future availability of TEC.

It can be argued that one of the factors for considering the efficiency of investment in the main transmission system is the demand for new transmission capacity. This, we believe, can best be measured through new users demonstrating a commitment to use the additional capacity provided. As described above, we support a user commitment in the form of a number of years of TNUoS payments with users required to make such a commitment once they have obtained their necessary consents. At this stage we believe there is sufficient certainty that the project will proceed and that any residual risk of stranded investment is minimal. On this basis an appropriate trigger for

beginning pre-construction of deep system reinforcement would be user commitment for, say, 10-20% of the capacity released by the reinforcement. For example, for a reinforcement releasing 500 MW of new incremental capacity the transmission licensee would receive the signal to begin pre-construction work on the scheme when users had committed to use 50-100 MW of the new capacity.

The second stage in reinforcing the main transmission system is the construction. We believe that the transmission licensees should assume responsibility for investment in infrastructure for system reinforcement in the same way as for growth in demand, where the necessary deeper investments are carried out without underwriting.

As with the pre-construction phase in order to ensure that investment is timeous and efficient, there needs to be a further trigger point for the start of construction of deep system reinforcements. Should Ofgem introduce a revenue driver mechanism, this could trigger the revenue driver in addition to triggering construction. The timing of this trigger should be mindful of the economic case for beginning construction (for example, the cost of constraints) and the operational management of the construction (for example, the availability of outages). On this basis, we would argue that the trigger should be determined on a scheme-by-scheme basis but should be no later than a user commitment for half of the capacity released by the reinforcement. For example, for a reinforcement releasing 500 MW of new incremental capacity where pre-construction works are triggered by user commitment of 50-100 MW, the transmission licensee would receive the signal to begin construction of the scheme when users had committed to use 250 MW of the new capacity.

Under this approach, any revenue driver would need to be triggered when the 50% of user commitment is reached. It would, however, need to provide funds for the entire capex of the specific project (i.e. not just the 50% that had user commitment) otherwise licensees will be unable to commence construction and will be explicitly incentivised to delay investment until there is a capacity shortage. This, in our opinion, illustrates the fundamental flaws in the revenue driver approach.

The triggers for pre-construction and construction of deep system reinforcements are illustrated in Figure 2 below.

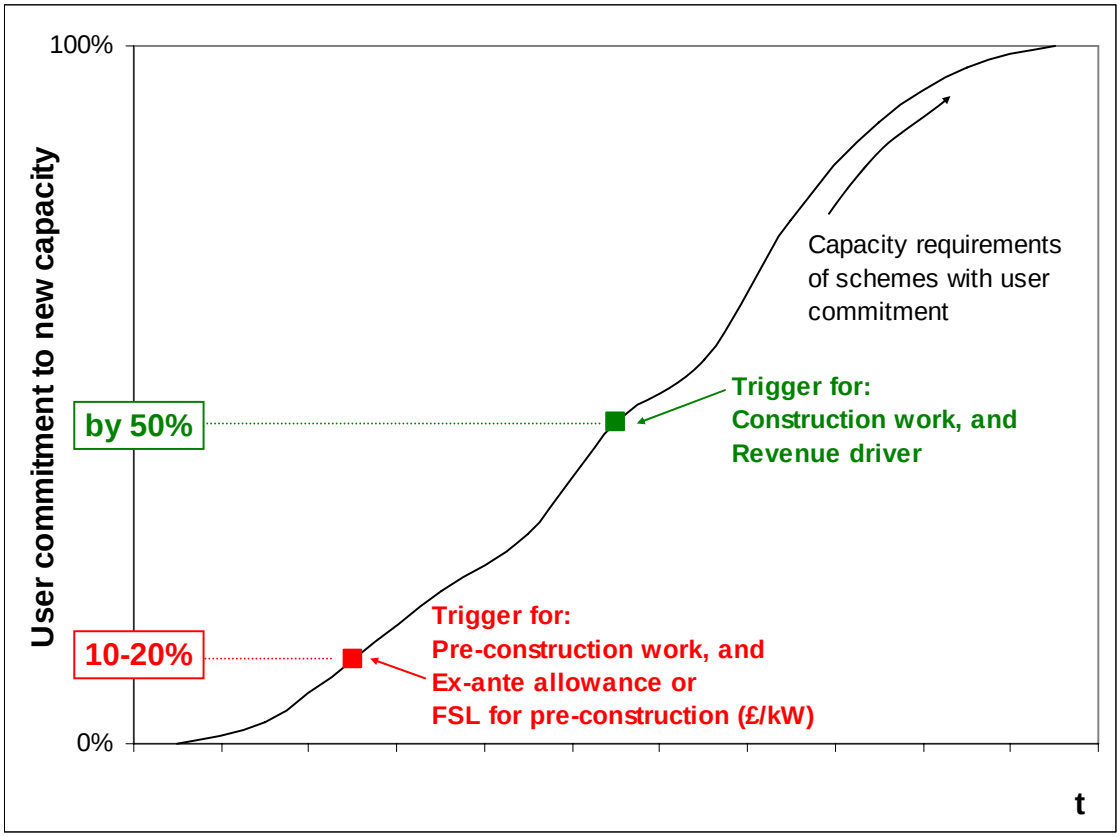

Figure 2 Triggers for pre-construction and construction of deep system reinforcements

In summary, for investment in the main transmission system, we believe that triggers should be defined for pre-construction and construction. These triggers should be based on the commitment of new users to use the capacity released by the investment. The trigger for pre-construction could be set at around 10-20% commitment to the capacity increment, and the trigger for construction when users commit to use half of the new capacity. These triggers should be linked to the funding decision made in the TPCR acknowledging that once a trigger point has been reached investment is efficient and should be recovered through the price control. There are some fundamental issues in relation to matching funding and user commitment that we do not think a revenue driver mechanism is capable of resolving.

Restricted rights prior to TEC

Currently CEC and TEC are delivered at the same time, although in principle, CEC could be delivered before TEC provided that users had the opportunity and an incentive to apply for a non-firm access. We believe that this can be best achieved through an incentive on the system operator, say a £/non-firm kW generated.

The most likely circumstance where non-firm access to the transmission system could be needed is for new users where firm access is dependent on deep system reinforcements. The local infrastructure works for a new user may be of short construction time whereas reinforcement works on the main transmission system may take many years to complete – resulting in a possible time gap between delivery of CEC and TEC.

We believe that non-firm grid capacity exists and can be made available. Non-firm capacity could take advantage of the fact that the transmission system is generally planned to "N-2" availability but operated to "N-1" standard. For a developing grid system, upgrades are undertaken to restore the system to a Licence compliant state in order to accommodate increased generation. In these circumstances it is likely, once a transmission upgrade has received all the necessary consents and increased capacity can be foreseen, all the generators that will make use of that upgrade could connect on a non-firm basis in the intervening period. Existing products such as LDTEC may be able to fulfil this requirement.

The possibility of new users being granted non-firm access prior to receiving TEC is a function of many variables including geographic location, CEC and type of generation. It is unlikely that non-firm access would be available to all new users. A simple ‘connect-and-manage’ approach could lead to excessive generation connecting to a relatively inadequate transmission system. Either non-firm availability would be very poor, or GBSO compensation payments would be very high. The benefit of a limited form of ‘connect-and-manage’ would be to relax the interdependence between generation connections and grid upgrades. However, this should be limited to the extent that non-firm capacity exists or compensation payments are economic.

None the less, in order to make best use of the existing transmission infrastructure, we believe that the options for non-firm access should be examined at an early stage in the connection process, for example when the generator obtains consents or when the trigger for deep system reinforcement is reached.

In summary, we believe that there are circumstances where non-firm access to the transmission system would facilitate the most efficient use of existing assets. To this end, we would support early consideration of the possible availability of non-firm products should a new user deliver CEC before TEC is

available and believe that this can be best achieved through an incentive on the system operator.

Unrestricted Access (TEC)

The final stage in obtaining transmission access is the provision of firm access to the system. In our opinion, the key questions at this stage are what the obligations – through a user commitment – are on the transmission sector to deliver the capacity.

A key milestone in delivering the transmission capacity is the obtaining of consents. The granting of consents is largely outwith the control of the licensees and we do not believe that it is reasonable for consenting to be included in the obligation. We do, however, support an obligation on transmission licensees to apply for consents timeously through a trigger for the pre-construction of deep system reinforcements. For example, as described above, we suggest a user commitment to use 10-20% of the capacity released by the reinforcement.

Following the granting of consents, we believe that "TEC in consents plus K years" is the most sensible option. In practice, the construction time for system reinforcements is dependent upon a number of variables including the scale and scope of the reinforcement, the location, and the outage programme; consequently, long line reinforcement works may take many years to complete. Our preferred option would be for K to be variable, otherwise K would have to reflect the worst case possibly meaning that connection could be unnecessarily delayed.

Access arrangements for new users on islands

Compared to new generators on the mainland, different issues are important to new generators on islands. Consequently, we believe that the access reforms that are proposed as a result of this consultation should not necessarily apply to the islands. For example, a significant issue is the cost and construction of subsea links. The island links may, therefore, warrant a different approach in terms of price control treatment and this will need to be reflected in the associated user commitment model. However, it will be vital to ensure that developers on the islands do not face disproportionate or discriminatory treatment.

Summary

An overview of our proposals for revised access arrangements is shown in the form of a timeline in Figure 3 below.

In order to consider changing the current access arrangements, the funding of load related capital expenditure in the future must be taken into account. Ofgem's preferred option of a revenue driver has significant implications for the financial security that is required from new users. Not least, it would clearly be inappropriate for users to provide financial security against assets for which the transmission licensee is in receipt of a revenue stream.

We believe that a key component of changes to access reform should be the introduction of user commitment for new users at the time when the scheme is granted consents. The commitment of a number of users could then be used as a trigger for beginning pre-construction and construction of deep system reinforcements – and, potentially, trigger funding through an ex-ante allowance or revenue driver. This would provide certainty to new users in the future availability of TEC.

A further key element of the proposed changes to the access arrangements is the transfer of risk from developers to transmission licensees. We agree that balance of risk under the existing arrangements is no longer fit for purpose and may be a barrier to competition; hence, we believe that it is right that some risk is transferred. This being the case, it is important that National Grid publish a methodology for FSL liabilities that is approved by Ofgem. This approval would ensure that Ofgem is comfortable with the degree of risk that is being transferred, and provide comfort to transmission licensees that efficient investment undertaken in good faith will be funded.

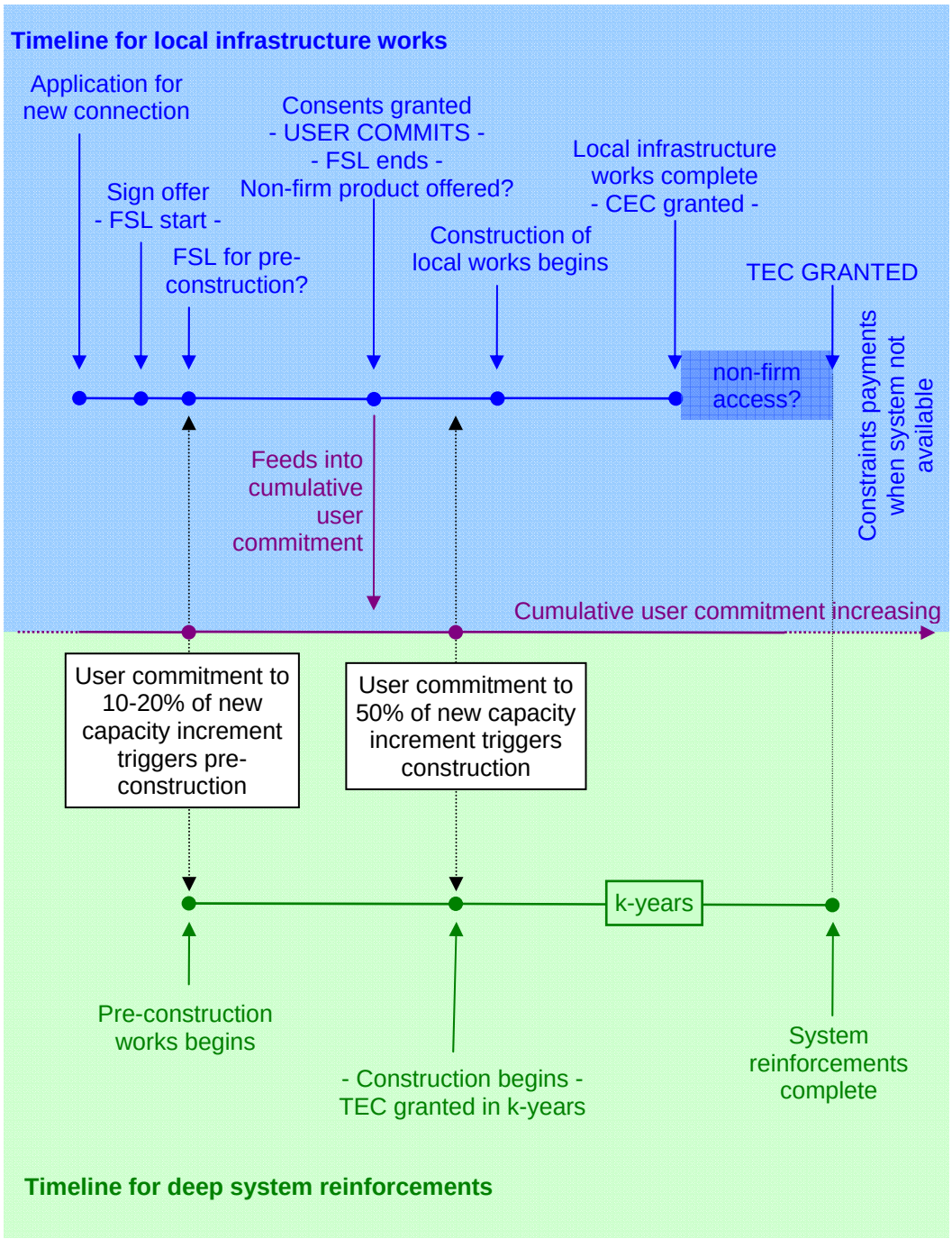

Figure 3 Proposed timeline for new access arrangements