

FAIRWIND STATKRAFT ORKNEY LTD
Horries, Deerness
Orkney, Scotland, UK
KW17 2QL
Tel 01856 741267
Fax 01856 741370

19th July 2007

Robert Hull
Director – Transmission
OFGEM
9, Millbank
London SW1P 3GE

Dear Mr Hull

Response to your open letter ‘Connecting the Islands of Scotland’

Thank you for the opportunity to contribute to your consultation process in regard to the very important issue of a strategic review of Scottish Island Connections.

Firstly I would like to outline our company and project and to set this in the context of the consultation and the particular relevance of the project to the Orkney connection.

We are Fairwind Statkraft Orkney Ltd (FSOL), which is a joint development between Fairwind Orkney Ltd an independent Orkney based company and Statkraft UK, which is a wholly owned subsidiary of the state owned electricity utility of Norway. Statkraft are primarily a hydro generation operation with over 98% of its power generation classed as renewable.

FSOL has signed a Construction Agreement and BEGA with National Grid Plc and a Connection Agreement with Distribution operator Scottish Hydro Electric Power Distribution Plc (SHEPD). We currently have a connection date of October 2011 for a TEC of 126MW. We have been providing final sums securities to National Grid since August 2005 and with SHEPD since February 2007.

The project for 126 MW of TEC is led by on-shore wind, though our company has a serious interest in generating from early stage development arrays of wave and tidal devices as soon as they become available and technically feasible.

Our wind sites have now entered the official scoping stage – with bird studies nearing completion. It is expected that we will put in full planning applications for some sites later this year.

We note at the very beginning of your letter that you point to the Islands’ rich resources in wind and marine energy. It is further encouraging to note the general strategic view with which you open the basis for the consultation, and the implication – at least – that Ofgem may be persuaded that there is merit in looking upon the Island connections as somewhat different to those on the UK mainland. We also note that you wish to balance developer’s requirements for economic projects on the one hand and limiting the costs and risks to consumers on the other.

We agree with your premise that a different regulatory approach may enable both of these aims to be realised and that a degree of innovation should be part of this thinking.

Where we are now

I would, firstly, like to describe the present situation as we find it in Orkney.

We must fully secure the advance services and construction costs of the 132 kV cable between Orkney and Dounreay and, further, from Dounreay to Beaully.

We were in receipt of a budget forecast for a twin circuit in 2003, which by October 2006 had doubled to around £90 million.

The TNUoS we have been quoted – and had confirmed on a number of occasions – by National Grid, since October 2006 is over £113/kw.

SHETL have begun the survey work through EIA looking at cable landfalls and through routes.

It is unclear whether we would be allowed to bring, within our TEC, some degree of capacity for early stage arrays of marine generation.

Other – smaller – projects, which may also include marine generation (wave/tidal), cannot join with our project (as the Orkney TEC) because they are much further back in the queue (or may not even have joined). This means that an Orkney connection may be built, say in 2011, but any new generation available at that time would have to wait many more years before another –additional – connection was made – although the generation could well be ready to go on.

What are the main issues?

Clearly the current situation is not sustainable.

The most significant issue is the extremely high level (£113/kw) of the TNUoS quoted. This alone would sterilise Orkney from any kind of power export in the form of electricity.

There is a lack of pressure on the TO (SHETL) to keep the capital costs of the connection down – as our 2 very different quotes seem to indicate.

The current GBSQSS requirement MAY be a significant factor in that it requires double circuit (n-1) provision. The significance of any change, as far as TNUoS is concerned, is, however, dependent upon the level of discount allowed in the charging methodology and the actual capital saving going from double to ‘single’ circuit.

The charging methodology and its relevance to Island connections is not clear. Even now there are several figures for TNUoS in print, some emanating from NG itself (a paper circulated in 2005) and some from recent reports from independent consultants (e.g. TNEI report (June 2007) sponsored by HIE and the Island Authorities). These sources quote levels around £40/kw uncapped and £30/kw with a DTI cap. It is probable that one source (2005) has been used for the basis of calculations in the TNEI report. It is difficult to reconcile these figures with those (£113/kw uncapped) given to us by GBSO in relation to our project.

The only logical conclusions (besides a problem with basic arithmetic) is that in one case the methodology has been used incorrectly or that very different assumptions have been made for key variables.

It is difficult to see, given the current difficulties, how a reasonable mix of projects and technologies could be connected effectively, efficiently and economically within and around the Islands.

Wider initiatives and reports/consultations

I would like, here, to raise a few pertinent other initiatives, consultations and reports which seem to have some bearing on Island connections – before moving on to look at the 3 options outlined in the open letter.

TNEI report

This report, sponsored by HIE and the Island Authorities, was published in June this year and looked at the 3 Scottish Island Groups.

Its main conclusions were that:

The solution for each group of Islands should be based on the requirements for that group rather than a one-size-fits-all.

The present 132 kV AC solution for Orkney was best and that it should remain, as it is in a high position (highest of all the Island groups) in the GB queue.

Projects should be grouped and stakeholders within each Island 'entity' encouraged to enable a more efficient connection –perhaps merging applications and sharing access.

Proposals for Offshore connections

There are changes mooted for offshore connections, which envisage single circuit provision (change in GBSQSS) and licensing of Offshore TOs.

Review of GBSQSS

Perhaps prompted by the prospect of connection to large offshore wind, but also looking at the load factor assumed for wind generation, which may be too high as an average.

Charging methodology

Is there likelihood that offshore assets will have a revised methodology?

Open letter – Options

It is our view that all the above factors should be borne in mind when assessing the options set out in the open letter.

Clearly any solution, which does not address the problem of an impossibly high TNUoS cannot lead to any prospect of sustainable development of the Islands' strategically important renewable energy resources.

A solution, which does not take into account a mix of projects and technologies, would lead to less efficient cable provision – and thus poorer value for the consumer.

The process of cable provision should be more transparent and be conducive to better access.

The solution should reduce uncertainty and allow a mix of connection in as short a time frame as possible.

Taking on the above criteria-

Option 1 –Status Quo

We believe that the key to the status quo (SHETL as provider) being the better option would be that it could guarantee to bring down the cost of using the cable (TNUoS) to a level where competitive and sustainable generation would be possible. To do that, SHETL would have to significantly cut the price it has so far estimated for the cable – perhaps by reducing to single circuit – and IN ADDITION there would need to be a change in the charging methodology. This would involve charging the real cost –over 40 years – of the connection asset to the user (but without the level of enforced cross subsidy to other TNUoS users). This cost would then be added to the zonal TNUoS at the point of connection to the mainland.

Some methodology where a group of projects could join together to use the cable would be an important consideration.

Option 2 – Merchant approaches – privately financing a connection to the main system

It is our view that the inclusion of this option and the opening of the debate on such provision are very important and may lead to more competitive pricing arrangements in option 1. The option has very significant merit, however, in its own right.

Firstly a merchant approach would see the risk of the enterprise –in the provision of transmission infrastructure between an Island entity and the UK Mainland – switch from part consumer/part developer (CAP 131 proposals) to all developer. That is, if we assume that the developer would be building the cable or part of a consortium. If projects were unlikely to be ‘real’ then there would be no cable built – hence an extremely small risk of a stranded asset. There would be no benefit in projects ‘waiting and seeing’- and holding on to TEC when they or a market led cable provider would be faced with significant costs from day one.

Secondly, a merchant builder would have a significant motivation to identify all possible real users of the cable and to build accordingly – since the ability to pay for and receive profit from the asset would depend on its long term marketability and use.

Thirdly, the question of how TNUoS would be calculated on the asset (and the lack of clarity which this brings) would cease to be an issue. The cable cost would be spread over 40 years with OM and a transparent rate of return built in. All users would pay an ongoing use of asset charge to the owner/operator and system. TNUoS would be payable at the point of connection (charging zone) on the UK mainland.

The capacity of mixed projects delivered by this – or any of the options – to the UK grid would benefit from a ‘connect and manage’ approach – which may see the capacity identified as high in the GB queue used to its fullest. There is, however, a very real risk that all the ‘queued TEC’ could be lost (forced to go to the back of the queue) through having to go through a Modification Application with the new cable connection (now probably T connected). This issue, alone, would be a blight on this option (and probably option 3) and would probably ensure that no merchant party(s) would come forward since projects would have little chance to export throughout the UK grid.

Clearly, Island connections would require a higher degree of strategic thinking than more ad-hoc connections more adjacent to current mainland grid links. This is especially valid if some incentive were to be considered which would allow a merchant cable to market a mix of tried and tested renewable generation together with space for strategically important technologies in the demonstration and early commercial phases. Any party considering building an expensive 40-year lifespan asset would look to some degree of ‘future-proofing’ and diversification rather than rely on a single generating technology. We believe that this would also be true of option 3 – but less so if the return on the asset was to be guaranteed by the Authority.

Option 3 – Tendering the right to build a connection and obtain regulated revenue.

This option seems to envisage a tendering process between existing TOs and other cable providers. The chosen party would be responsible for building, maintaining and receiving a regulated, but guaranteed return on the asset, much as in option 1.

Here, we cannot see any incentive for innovative use of the cable – merely an incentive to look short term and build to low cost. A TO (who may be pre-licensed at the start of the tendering procedure) may lose incentive once the asset is agreed as their return on investment will be likewise guaranteed.

There seems to be some discussion invited as to whether or not a generator should be allowed to bid. This, in turn, looks like a hybrid between options 2 and 3. In this case a generator may look forward to a fixed return on the asset if successful in a bid – but with limited incentive to market the connection to other users.

The question of TNUoS still arises with this option. Presumably the asset would be part of the UK asset base and fully under the charging methodology. As we have already pointed out, this methodology for Island connections is not transparent and would lead to immediate short term loss of investor confidence due to high uncertainty.

The tender process itself may be necessarily prolonged which could well threaten the connection of existing TEC holders (within the GB queue) as they may be ‘timed out’ and their TEC withdrawn by GBSO.

Looking at all the issues – option 3 is not the way to go – especially in the case of the connection to Orkney.

Conclusion

It is our view that both options 1 and 2 should be investigated further. Parties who may be interested in a merchant approach should be given comfort that early talks would not be wasted.

SHETL should be motivated to review its approach to cable provision and to come up with robust proposals to allow for a competitively priced cable which would allow for reasonable use of system charges and a more flexible approach to mixed use.

Yours sincerely,

Dennis Gowland
(Chairman – FSOL)