

Robert Hull  
Director - Transmission  
Ofgem  
9 Millbank  
SW1P 3GE

Paul Whittaker  
UK Director of Regulation

paul.whittaker@uk.ngrid.com  
Direct tel +44 (0)1926 653190  
Direct fax +44 (0)1926 656520  
Mobile +44 (0)7776 170735

[www.nationalgrid.com](http://www.nationalgrid.com)

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Dear Bob

### **Connecting the Islands of Scotland**

I note with interest the thoughts outlined in your letter entitled "Connecting the Islands of Scotland" and welcome the opportunity to respond to these. In particular, I note that the favoured approach, as expressed in your initial views, shares a number of features of the regime proposed for offshore transmission.

As the complexities of establishing a competitive tender process for offshore transmission become clear, I am concerned that the proposed approach for connecting the Scottish Islands will be overly complex and that the costs will outweigh any benefits to consumers compared to using the established regulatory approach. It would be helpful if we could meet to discuss my fundamental concerns with the proposed approach. I am, of course, raising these directly with BERR as well.

My comments on the three options you have outlined for the connection of the Scottish islands are as follows:

#### **1. Status Quo – a Monopoly Approach**

You have highlighted a concern that if a monopoly approach did not deliver the least cost solution, the viability of island generation projects could be undermined by unduly high charges and the network assets would face a greater risk of becoming stranded.

While you highlight the risk that GB consumers might be exposed to these costs, Ofgem's ability to approve or suspend funding for these assets (at the outset or at any point in the future when such inefficiency becomes apparent) means the stranding risk also lies substantially with the investor. Under these conditions, and given the other incentives that will arise under a price control, the network investor (whether an existing onshore licensee or a new licensee appointed by tender) will face incentives to select an appropriate design and then build, operate and finance it efficiently.

## 2. Merchant

A merchant approach provides a great deal of flexibility to developers but requires the network assets to be funded at the developer's cost of capital rather than the lower rates associated with serving a larger user base. Given that Government has introduced the option to cap transmission charges, it is arguable whether any developers will wish to forego the effects of such a cap by promoting a merchant approach.

It is also unclear at this stage whether (and how) the newly interconnected island systems would be integrated into the GB electricity market and therefore unclear as to the obligations arising under this approach on the developers, particularly in respect to island based consumers. Would these interconnectors be bi-directional for example, supplying local demand at times of low output from renewable sources? What revenues from such users to the network owners would be appropriate for such circumstances?

## 3. Tender

A competitive tender may better discover the efficient cost of financing such network assets compared to Ofgem's cost of capital calculations for network monopolies. It is unclear whether this approach would provide sharper incentives than traditional price controls for efficiently constructing island connections. Compared to the merchant solution, it will enable risk sharing with consumers (with consequentially lower costs of capital). However, I have serious concerns around the tender approach:

- a. **Proportionality:** The transaction costs associated with developing a full blown tender process, given the limited number of transmission developments involved, could easily outweigh any benefits from the tenders (especially as Ofgem already note that discovered costs of capital may well be higher than those Ofgem set for the onshore monopolies).
- b. **Uncertainty:** The uncertainty created during the development of a new process may peak at the very time that crucial investment decisions are required.
- c. **Timescales:** Any thorough tender process will take a number of months (if not years) to complete which will need to be factored into the overall plan.
- d. **Co-ordination:** The value of connecting the Islands of Scotland is dependant on the delivery of significant mainland transmission development as well as infrastructure on the islands themselves. It is unclear as to whether the tender process can deliver necessary transmission infrastructure in the appropriate timescales if it is not tied closely to mainland developments.

I am not convinced that the benefits that might be delivered by a competitive tender process will justify the additional costs, risks and uncertainties created by the process itself. The investments required to connect the Scottish islands to the GB Transmission system are large and are best managed through the proven regulatory mechanisms currently used to manage onshore Transmission Owners.

Yours sincerely

*[By e-mail]*

Paul Whittaker