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Dear Bob,

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

SSE welcomes the opportunity to respond to the Ofgem consultation on options for connecting the Islands of Scotland.

We have previously written to Ofgem (see our letter of 25<sup>th</sup> May 2006 to David Gray) expressing, in some detail, our concerns over the proposal that the transmission connections to the Scottish Islands could be put out to tender. All of the concerns expressed in that letter continue to be relevant.

Whilst we fully agree that a balance needs to be struck between meeting developer's requirements, connecting projects as economically as possible and ensuring that customers get value for money, in our view, for the Scottish Islands in particular, this will best be met through the existing regulatory regime. Scottish Hydro Electric Transmission Ltd (SHETL) has consistently been shown to be an efficient provider of major transmission infrastructure projects, a fact that has been acknowledged by Ofgem and its consultants during the recent transmission price control review. Such assessment of the transmission owner's investment plans is an integral part of any price control review.

SHETL has an obligation to develop its transmission system to meet the demands of its customers, along with an obligation to prepare a connection offer for generators in the Islands (including any upgrades to infrastructure), so that National Grid can issue a connection offer to the generator. We are concerned that third party construction and ownership of lines to connect different parts of the transmission system on the islands and mainland could undermine these existing licence obligations.

We do not believe that the Scottish Islands should automatically be treated as an extension to the proposals for offshore transmission connections. Whilst there are some similarities, there are many differences. One of the fundamental differences between connecting the Scottish Islands and connecting offshore transmission is that the islands have end consumers, both domestic and non-domestic, as well as new generation. There are therefore licence obligations on the incumbent distribution licensee, Scottish Hydro Electric Power Distribution, to secure supply to these islands.

We strongly believe that 'whole island' solutions, which take cognisance of both demand and generation requirements are necessary.

Currently it is unclear what Ofgem's criteria for deciding between the regulatory and competitive routes are. For example, we would fully expect any major overland reinforcement/link (such as the proposed mid-Wales link) to be carried out under the existing regulatory regime. We can see no fundamental difference between such a project and the proposed island reinforcements/links. In our view, the existing regulatory approach should continue for all future transmission reinforcements/links.

#### *The options for asset ownership*

Ofgem have expressed concern that were the existing transmission owner not able to deliver the least cost connection solution, the resulting transmission charges would be inefficiently high. Ofgem have therefore identified three alternatives for the ownership of high voltage transmission circuits to link the GB mainland to Orkney, Shetland and the Western Isles:

- The existing transmission owner (SHETL) would build and own the circuits in accordance with the current regulatory framework;
- A licensed party would build, own and operate a discrete section of transmission network outside of a price control regime; or
- A competitive tender would be used to determine a licensed party that would build and own a discrete section of transmission network under a price control regime.

#### *The Existing Regulatory Regime*

In our view the existing regulatory framework is effective and fit-for-purpose, and is the best mechanism to deliver the necessary transmission links to the Scottish Islands. As noted in the consultation document, this approach is likely to deliver the simplest, lowest cost and quickest solution. In addition there are a number of practical reasons why the existing approach is to be preferred over any other:

- The existing contractual framework and industry governance procedures already provide sufficient flexibility to meet the requirements of developers of renewable generation;

- The existing contractual framework and industry governance procedures will ensure that the needs of demand customers on the islands are considered and met;
- There is sufficient flexibility in the existing industry standards to facilitate the most economic connection design and allow for innovative engineering solutions;
- Existing European directives require that the procurement of all electrical cables and equipment is fully competitive, hence ensuring that the investment is least cost; and
- The regulatory framework is sufficiently robust to ensure that, over-and-above the discipline of the competitive procurement process, the investment is undertaken economically and efficiently.

Furthermore, in our view, the allowed return of a portfolio asset owner would be lower than that required by a private investor in a single asset. Additionally, the recent transmission price control settlement has provided assurance that such large projects can be suitably financed.

Under our transmission and distribution licence obligations we have progressed a whole Shetland solution that provides an innovative, low cost connection with demand secured through back-up generation. Such an innovative solution requires flexibility in the GB Security and Quality of Supply Standard and, at the very least, requires that the transmission charging regime is cost reflective. We have raised serious concerns over the current charging regime on a number of occasions. For the Scottish Islands in particular, we believe that the current charging regime is not cost reflective and have previously written to Ofgem on this (see our letter of 27<sup>th</sup> February 2007 to Alistair Buchanan).

#### *Merchant Approaches*

The consultation document acknowledges that the second of the possible ownership options (the merchant approach) would involve substantial risk and may lead to the poorly co-ordinated development of connections. We fully support this conclusion. Furthermore, without significant regulatory oversight including regard to price, this approach would deliver little or no benefit to demand customers on the Scottish Islands. Hence, in our opinion, pursuing a merchant approach is not in the best interests of GB consumers.

#### *Competitive Tendering*

Although acknowledging the merits of the existing regulatory framework, Ofgem have expressed concern that the existing transmission owner may not be able to deliver the least cost connection solution. A competitive tender process to determine the transmission owner is proposed in order to address this perceived risk.

Ofgem suggests that a competition in transmission ownership could be expected to provide greater scope for innovation and increased flexibility for generation developers. Given the innovative approach described above, we doubt this will be possible.

Furthermore, Ofgem accepts that a tendered approach would be complex and there would be significant time and cost involved in its development. It is clear that developing, running and managing a competitive tender will impose significant additional cost and time on the industry. For comparison, it has been recently estimated that the costs for market participants in offshore electricity transmission could be up to £1 million per bidder<sup>1</sup>. These costs will have to be recovered from consumers. With regard to time, there is a very real risk that current generation projects will be jeopardised by the delay that a new competitive tendering process will introduce.

Any move away from the existing regulatory regime raises questions about how the current industry framework would be adapted to accommodate the new arrangements. In particular, we believe that the following key questions would need to be addressed:

- How would existing generators on the islands obtain capacity and what level of security would they be entitled to expect? New rules would need to be developed and experience indicates that these tend to be complex and require extensive regulatory oversight.
- Would the licence holder for the link be separate from the generators or could the generator hold the transmission licence? If so, what would the generator's licence look like?
- Would the GBSO or the licence holder operate the link? How would this interface with the GB trading arrangements in terms of the Grid Code, BSC and CUSC?
- Would the generators/developers of the link have exclusive rights to the capacity? Without being able to reserve capacity we do not see how a generator would be able to justify proceeding with the link project. In our view, it is not clear how such capacity reservation would sit with Ofgem's justification for BETTA or, indeed, recent developments across the EU in relation to capacity reservations.
- Third party ownership options effectively imply "deep" charging methodology for generators on the islands, with the current super-shallow methodology applying on the mainland. We believe that any proposal to introduce separate charging arrangements on the islands would prove that NGC's charging model does not achieve the relevant objectives in terms of locational signals and cost reflectivity. In our view, a fundamental re-think of transmission charging across the board would therefore be required.
- Applying separate charging arrangements to the mainland and the islands would raise obvious issues of discrimination. We believe that such an approach would be vulnerable to legal challenge under the Renewables Directive, which prohibits

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<sup>1</sup> Licencing Offshore Electricity Transmission – A Joint Ofgem/DTI Consultation. Partial Impact Assessment. November 2006

discrimination against renewable energy sources particularly in island areas. The resultant legal uncertainty would be likely to lead to delays in bringing forward projects.

- In our view, requiring a generator to pay deep connection would imply that the island generators should not pay TNUoS at all. This would need to be confirmed; otherwise a TNUoS charge on top of deep connection would imply “pancaking” of charges, which is demonstrably inconsistent with EU Directives. Double charging would also clearly undermine the economics of the island links, particularly if National Grid’s current locational charging model remained in its present form.
- There is then the more general question of how these arrangements would ensure that the transmission system be developed in an integrated manner? If a link was to be constructed between two points on the existing GB transmission system the existing licensee would have to develop its network to cater for the additional power flows. How then would competing demands for mainland transmission capacity between island and mainland generators be determined?
- How would the distribution business secure capacity to cater for demand on the islands and how would charges be determined? What level of security would the distribution company be entitled to expect?
- Ofgem would need to confirm that SHETL would not be precluded from bringing forward proposals for a link to be developed as an excluded service. In our view, if the most likely developer is excluded from the potential construction of the link, the chances of no connection to the islands ever being built will significantly increase.
- Finally, If Ofgem are to open up the island links to third party ownership, SHETL would need to be removed of its current legal obligations in regard of providing connections to generators on those islands.

These quite fundamental questions would have to be resolved prior to development of any new regulatory regime. The time needed to resolve these issues could threaten the viability of current island generation projects.

Ofgem acknowledge that determining the winner of any tender process would hinge on factors wider than price alone. However, this would appear to contradict the primary reason for considering competitive ownership i.e. that the existing transmission owner may not be able to deliver the least cost solution.

In addition Ofgem suggests that there may be some international precedent for a competitive tender to select a transmission owner. Of the international comparators with which we are familiar e.g. in Australia (including Basslink) and South America, the key benefits that were derived through the competitive tender process are already part of the GB transmission arrangements i.e. a fully competitive procurement process and flexibility in design standards.

As a consequence, we do not believe that the introduction of new asset owners will be in the best interests of developers, the island communities or GB consumers as a whole.

We are firmly of the view that the existing regulatory framework is the best mechanism for delivering the most economic and efficient investment in electricity transmission infrastructure. As described above, the existing contractual framework, industry governance procedures and standards are sufficiently flexible to allow for innovation in designing the connection. Furthermore, the economics of the investment will be tested by the market during the fully competitive procurement process. This will be the case regardless of the ownership of the asset. Consequently, we do not agree that a competition for asset ownership will result in a lower cost solution.

In conclusion, whilst we are generally supportive of Ofgem's work to promote competition and the competitive discipline in the gas and electricity industries, we do not believe that it is appropriate to introduce competition for the ownership of electricity transmission assets. In particular we do not believe this is appropriate for connecting the Scottish Islands.

Customers of the electricity transmission owners already benefit from competition through established competitive tender processes for the design, procurement and construction of transmission assets. It has not, in our view, been demonstrated that consumers would benefit further from competition in ownership and, in particular, that any potential benefits would offset the significant additional costs (financial, time, uncertainty and risk) of a new regulatory regime.

In our opinion, the most economic and efficient solutions to necessary transmission reinforcements can be delivered under the current regulatory framework with existing open competitive procurement, price control regulation (including a regulated rate of return), cost-reflective use of system charges and, where necessary, the continued provision of back-up generation to secure demand.

I hope that these comments are helpful, and if you would like to discuss any of the points raised further then please give me a call.

Yours sincerely,

**Malcolm Burns**  
**Regulation Manager**