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Dear Colleague

### **Connecting the Scottish Islands - update**

In June 2007, Ofgem published an open letter on 'Connecting the islands of Scotland' ('the June 2007 open letter')<sup>1</sup>. The letter outlined our high level thinking on options available for regulating transmission connections to the islands of Scotland. It followed on from the work undertaken as part of the Transmission Price Control Review (TPCR) where we noted that there would be merit in considering other approaches to regulating such transmission connections.

The June 2007 open letter was the first step in considering different regulatory approaches. The letter set out the view that, rather than these connections being progressed by the existing transmission licensee (Scottish Hydro-Electric Transmission Limited or 'SHETL') under the normal regulatory framework, there may be merit in adopting a different regulatory approach. We suggested that allowing companies to compete to construct an island connection may deliver more timely connections and provide greater value for money.

In March 2008, SHETL asked Ofgem to modify its price control allowances to enable it to fund the investment in proposed connections to the Western Isles and Shetland such that the contracted connection timetables could be achieved. This letter provides our response to the request and our decision in relation to the proposed connection through GB internal waters to the Western Isles and discusses developments relevant to our consideration of this issue.

The proposed transmission connection to Shetland would require investment in transmission outside of the internal waters of Great Britain. We are considering the way that it would be legally possible for SHETL (or another provider) to be licensed to take forward this connection. As a consequence of the need to explore further these legal issues, the Authority has not yet made any decision relating to the proposed Shetland connection.

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<sup>1</sup>'Connecting the islands of Scotland', Ofgem open letter consultation, June 2007, document number 138/07

## Background

### *The Transmission Price Control Review (TPCR)*

As part of the TPCR, we were asked by SHETL to consider how possible connections to the islands of Scotland may be accommodated within the price control framework. This consideration was set against a background of existing connection applications. SHETL indicated that in excess of £1 billion might be required to deliver these connections, which represented in excess of five times the investment required in the rest of SHETL's transmission network over the same period.

The TPCR final proposals concluded that since there was uncertainty surrounding the likelihood of connections proceeding and the potential timing and scale of the investment, it would be difficult to develop robust mechanisms for dealing with such investment decisions within the current price control framework. Ofgem's final proposals for the TPCR approved funding to enable SHETL to recover the efficient cost of pre-construction works (in the period leading up to the application for consents) to identify the most cost effective solutions for connections to the Western Isles, Shetland and Orkney. The final proposals identified two possible approaches going forward. First, re-open SHETL's price control when further information became available, with the assumption being that it would be appropriate to apply existing regulatory arrangements to finance the links. Second, open up the provision of links to alternative providers, noting that a competitive approach could potentially bring quicker delivery, drive down costs, encourage innovation, give more certainty to ex-ante costs, and reveal cost information.

### *Developing the regulatory framework for the Island connections*

The June 2007 open letter was the first step in considering the regulatory approaches that might be adopted for transmission connections to the islands of Scotland. It stated that we consider there may be scope for competition to be introduced into the provision of transmission assets. We recognised that allowing such competition would be consistent with the approach that Government is taking with respect to the provision of transmission assets in offshore waters that are required to connection offshore generation. The letter outlined that a competitive tender approach (similar to the approach being developed for offshore transmission) may be appropriate for the Scottish islands connections.

In the June 2007 open letter we identified the key characteristics of three possible approaches for regulating transmission connections to the Scottish islands, acknowledging that significant work would be required to fully develop a coherent regulatory approach.

The three approaches we identified were:

- (i) **Status quo:** Least change option. Assuming there is likely to be interest in connecting generation in the islands based on a cost-reflective network charges for generators in that area, and assuming there was scope with the existing regulatory framework to facilitate this, Ofgem could provide funding for an efficient and economic level of expenditure to SHETL. SHETL would be expected to earn their existing regulated rate of return on this investment.
- (ii) **Merchant approach:** Similar to interconnector licensing approach. This would allow a licensed party to build, own and operate a section of line to the main transmission network. No regulated revenues would be provided to finance the connection. The owner would set its own charges, although the approach to deriving charges would be likely to have some regulatory oversight. Consumers would be faced with no risk of incurring unnecessary costs.
- (iii) **Tendering approach:** Use competition to determine which company would construct and operate the connections in return for regulated revenues to

fund the connections. The competition would be designed to achieve the lowest cost solution. There are a number of competitive tender models that might be feasible, however the June 2007 open letter set out that an approach consistent with the model then being considered for offshore might be appropriate. The offshore competitive model has been further developed since then, but the competitive principle remains broadly the same – i.e. the process would identify the party that will receive a regulated income over the life of the asset.

Our initial thinking was that there may be merit in allowing competition to construct island connections. We noted that this approach may reduce the costs to consumers and may also benefit developers if it allowed more scope for flexibility in the commercial and regulatory arrangements surrounding the proposed investment.

We sought views on the practicalities of these options and suggestions on other approaches that may be practicable.

Developments since the final TPCR proposals and our June 2007 open letter that impact on this area of work are discussed below.

### **Developments since TPCR and June 2007 open letter**

#### *SHETL's proposed transmission connections to Scottish islands*

In March 2008, SHETL wrote to Ofgem to advise that the pre-construction works for the Shetland and Western Isles connections were nearing completion. SHETL requested a price control adjustment to provide the additional funds required to construct these proposed connections.

SHETL has advised that it has now completed its public consultations on these proposed connections. In addition, SHETL has advised that the seabed survey for the Western Isles connection is completed, and that SHETL is in the process of taking forward the seabed survey for Shetland.

SHETL has indicated that it could complete the 450MW transmission connection to the Western Isles by 2012 and the 600MW connection to Shetland by 2013, consistent with the contracted connection dates of a number of island generators. The cost of these links is estimated at £188 million for the Western Isles and £272 million for the connection to Shetland (based on single circuit non-GB SQSS designs)<sup>2</sup>. SHETL's timetable is based on submitting consents applications for the proposed Western Isles link in October 2008 to begin construction in late 2010, and for Shetland to submit consents applications in March 2009 and to begin construction in early 2011 (factoring in several months lead time for cable manufacture and allowing an appropriate period for tendering and procurement). Details of the Western Isles scheme and the public consultation are published on the Scottish and Southern website<sup>3</sup>.

#### *Developing a competitive regime for offshore transmission*

The government is committed to developing a competitive approach for the delivery of offshore transmission connections. BERR's impact assessment for offshore transmission<sup>4</sup> demonstrated that there are significant benefits for consumers under a competitive regime, compared to funding offshore transmission under the existing regulatory framework.

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<sup>2</sup> Ofgem would give careful consideration to all of the potential impacts arising where a transmission licensee proposes to take forward a non-GB SQSS compliant design, to ensure there is no adverse impact on other users and the transmission system, and ultimately to the costs and/or security of supply for consumers.

<sup>3</sup> <http://www.scottish-southern.co.uk/SSEInternet/index.aspx?id=480>

<sup>4</sup> <http://www.berr.gov.uk/files/file27138.pdf>

The regime currently being developed for offshore transmission is based on Ofgem running a competitive tender processes using the powers under section 92 of the Energy Act 2004, with the first such tender scheduled for April 2009, enabling a licence to be granted to successful bidders to participate in the activity of transmission offshore by April 2010. The transitional arrangements being developed mean that projects currently under construction can be adopted into the tender process, meaning that there are no construction delays for generator connections.

Ofgem is currently working with the government to develop the significant number of changes to licences and industry codes necessary to implement the proposed competitive regime for offshore transmission. We consider that the offshore transmission regime should deliver long term benefits to consumers through competition in transmission asset provision.

### *Implementing a competitive approach for Scottish islands*

Since publishing the June 2007 open letter on the potential to adopt a competitive approach to the delivery of transmission connections to the Scottish islands, we have considered respondents' views and the views presented at the seminar we held in August 2007.

We received 24 responses to the June 2007 open letter. These are available in full on Ofgem's website. We note that opinion was broadly split between continuing with the status quo and the adoption of one of the two suggested models (merchant and tendering). Several respondents commented that change should be introduced only if there were tangible benefits (costs savings, environmental benefits, improvement in timescales for connections). Some respondents commented that SHETL had already undertaken a significant amount of work with regard to specific island connections, and were concerned this would be wasted if a new model is introduced. A number of respondents commented that the option that delivered the transmission connections soonest should be adopted.

In the light of these responses, we have given further consideration to the practicalities of developing and implementing a competitive approach for transmission connections to the Scottish islands. We recognise the importance of striking a balance between developing an appropriate regulatory framework for island connections in the long term and the interests of developers and consumers in the short term.

We believe that developing a competitive regulatory framework to apply to Scottish islands connections (including developing and implementing appropriate transitional arrangements in relation to projects already in development) would require further significant work as well as a significant number of changes to licences and industry codes. The legal power to develop a competitive regime for offshore transmission does not extend to onshore transmission assets. As the offshore arrangements do not confer the legal power to implement the required code changes to support a competitive regulatory framework for Scottish islands connections, such amendments would need to be developed and progressed through normal industry governance arrangements, which can take several months to reach a conclusion. We recognise there are other risks that are outside Ofgem's control that could threaten the delivery of Scottish islands connections, such as delays in parties obtaining necessary consents (although we note that the Scottish Government has committed to speeding up the consents process for renewables)<sup>5</sup>. However, we consider that the need to implement changes to support a competitive approach for Scottish islands connections represents a significant risk to the timely completion of the proposed connections to the Western Isles and Shetland.

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<sup>5</sup> <http://www.scotland.gov.uk/News/Releases/2007/12/06144432>

## *Transmission Access Review*

In the context of the Transmission Access Review, amongst other things, we have noted that in order to encourage the transmission owners to deliver transmission capacity in a timely and efficient manner, there may be merit in developing a new incentive mechanism in relation to the significant transmission investment required to deliver the government's 2020 renewable targets. Should SHETL's proposed connections be delivered under the current regulatory framework, we consider there is merit in developing strong incentive arrangements to ensure that value for money is maximised for the consumer.

### *Geographic extent of legislative prohibition and transmission licence*

We consider that while there is merit in considering the extent to which the principles established for the offshore regime might be applied to the regulation of other transmission infrastructure, such as connections to the Scottish Islands, it is also important that the regulatory framework for the Scottish Islands connections does not undermine the effective operation of the offshore transmission regime.

In light of this concern and in view of SHETL's request for price control funding for the proposed connections to the Western Isles and Shetland, we have given legal consideration to the geographical extent of the legislative prohibition on transmission activities and the geographical scope of the transmission licence. We have also given legal consideration to the implications of the extension of the legislative prohibition within the context of section 89 of the Energy Act 2004 and the anticipated amendments to the transmission licences to be designated by the Secretary of State under section 90 of the Energy Act to introduce the offshore transmission regime.

Our initial legal consideration suggests that SHETL's existing transmission licence has sufficient geographical coverage to enable the proposed connection to the Western Isles to be delivered under the existing regulatory framework. We also consider it would continue to be able to do so once the offshore transmission regime comes into effect, as the proposed route of the connection passes through internal waters only, and as it does not connect offshore generation, would not fall within the definition of offshore transmission once the offshore transmission regime is implemented. However, it is unclear whether the geographical scope of the licence extends sufficiently to enable the connection to Shetland to proceed given that the proposed route passes through territorial seas and beyond. We are giving further legal consideration to this issue.

### **Impact on competitive approach for Scottish islands**

We remain committed in principle to using a competitive process for significant new transmission investments wherever possible and in circumstances where the scope for cost savings outweigh the costs and the risks associated with a competitive approach. In the case of the proposed Western Isles link, we need to strike an appropriate balance between the potential benefits from adopting a competitive approach and the changes required to facilitate such an approach. We also need to be mindful of the potential impact on development timescales. We consider that in this particular instance, adoption of a competitive approach may unduly delay renewable generation currently contracted to connect on the Western Isles by 2012/13, which may impact on the delivery of the governments 2020 targets.

We therefore consider that, subject to responses to this letter, it would be appropriate to enable SHETL to take forward their current proposal for establishing 450MW high-voltage DC subsea and underground link between the Western Isles and the mainland transmission system (Beaully to Grabhair) by reopening their price control and developing an appropriate incentive mechanism to provide funding for this proposed connection.

Under this proposed approach the indicative costs provided by SHETL will be subject to scrutiny by Ofgem. The cost of delivering these connections would only be included in

SHETL's agreed price control if we are satisfied that SHETL's proposals are the most economic and efficient means of delivering the connections under the existing framework. We would also want to reappraise our view on the most appropriate way forward for this connection if there was a substantial change to the estimated costs or delivery timescale of the proposed link because this might imply greater potential benefits of a competitive approach.

The Authority will make its decision in respect of the Shetland link following further legal advice on the territorial extent of the transmission licence.

We propose to continue to explore the different approaches for the longer term framework for regulating future connections to the Scottish Islands. We consider that there continues to be merit in exploring the potential for a competitive framework and would welcome further views from industry on this matter.

### **Way Forward**

Subject to responses to this open letter, we intend to consult on modifying SHETL's price control allowance to establish an appropriate level of funding for the Western Isles connection. In the near future, we will be developing and consulting on the new incentive arrangements proposed under TAR, to apply from April 2009. We consider it may be appropriate to develop and consult on the incentives arrangements to apply to the Western Isles (and potentially Shetland) connection in that context.

We would welcome views on the issues discussed in this letter by 14 October 2008. Please email your response to [lesley.nugent@ofgem.gov.uk](mailto:lesley.nugent@ofgem.gov.uk) or address it to Ofgem, 70 West Regent Street, Glasgow G2 2QZ.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Stuart Cook', with a long horizontal line extending to the right from the end of the signature.

**Stuart Cook**  
**Director, Transmission**