

Offshore Transmission Team  
Ofgem  
9 Millbank  
London  
SW1P 3GE

12 January 2009

Dear Sir/Madam,

## **OFFSHORE ELECTRICITY TRANSMISSION – POLICY UPDATE**

ScottishPower is grateful for the opportunity to comment on your policy update paper published on 20 November 2008. This letter is written on behalf of all ScottishPower businesses including SP Energy Networks, our generation and trading business, and ScottishPower Renewable Energy Limited.

The successful development of offshore wind and fulfilling the potential of wave and tidal stream generation is essential if the UK is to meet its targets for renewable energy and, in particular, meet the objective of 33GW (including 8GW from Rounds 1 & 2) of offshore wind energy by 2020. We support the Government's renewable ambitions and will work with it to realise its goals.

We welcome the acknowledgement of the importance of a coordinated approach for Round 3. To achieve this in practice, a single OFTO will need to develop the network for each Round 3 development zone, based on a planned overall infrastructure that could be developed on a suitably phased basis. To achieve the very significant export capacities proposed in Round 3, a strategic view of the overall infrastructure must be established. We think that reacting to individual requests for connections, even where grouped together within a framework of an annual window, will inevitably lead to an inefficient design and ultimately increase the cost to consumers. We therefore ask Ofgem and DECC to consider how best to ensure that the strategic approach can be maintained.

The policy update raises two further key issues – unbundling and risk allocation – which apply across our business and which are considered below.

### Unbundling

We believe that the update misunderstands the impact of the "Third Package" liberalisation directive on offshore transmission. This is important because as a generator, we want the largest choice of OFTOs to be able to bid in the auction so as to ensure the most cost effective solution. Given the current credit situation, there is a risk that potential OFTOs will find it difficult to raise finance and any restriction as to participation in the market can only make this worse. Similarly, as owner of a networks business, we would like to opportunity of being able to participate (on appropriate terms) in this important area.

In our view, the third package does not necessarily forbid a generator from acting as an OFTO. In particular it offers the option of a derogation for vertically integrated undertakings which can guarantee a greater extent of independence than the Independent Transmission Operator (ITO) model. It seems to us that the arrangement of the GBSO, combined with the business separation rules that are currently in place, means that the overall degree of independence for the existing Scottish transmission networks is already greater than the ITO system. In the event that this could not be demonstrated with the current arrangements, there would be the opportunity to consider enhancements.

This issue will need to be assessed for the onshore Scottish Transmission systems in any event. It seems to us that whatever solution is arrived at onshore is likely to be equally applicable, both as respects the Scottish Transmission owners participating as OFTOs and also in the event of generators acting as OFTOs of last resort (on the assumption that they are prepared to put in place separation arrangements analogous to those of the Scottish Transmission owners). The position outlined in Chapter 2 of the policy update would only apply if there was no solution, other than full ownership unbundling, for the Scottish Transmission networks – an outcome which would be clearly contrary to the UK's policy in seeking and obtaining the derogation.

#### Allocation of risk

It is tempting to see the allocation of risk as a zero sum game between OFTOs and generators. We do not see it that way; on the assumption that OFTO bidders act rationally in placing their bids, any risk which they are asked to bear will be reflected in the price charged to generators. And any risk retained by generators will have to be built into their project models. There must be clear criteria for re-openers, otherwise risks may be counted by both parties, leading to a less efficient outcome.

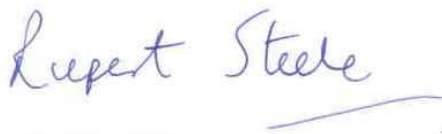
The risk allocation most likely to facilitate offshore development will take account of these factors. It will avoid creating unnecessary risk through asymmetric incentive mechanisms and will take account both of the risk appetite of the parties (generators are likely to be working at much higher rates of return than OFTOs) and of whether any party is in a position to manage each particular risk. In broad terms, this will leave with the OFTO those risks which it is well placed to manage and pass other risks on to the generators.

We also think that there should be scope to vary the risk allocation if the parties wish it. If the generators and potential OFTO agree that they would prefer a different risk allocation to the one proposed by Ofgem, then it would be sensible to facilitate giving effect to this.

#### Conclusion

I attach annexes giving their further comments on points of detail written respectively by our networks and by our renewables/wholesale businesses. Please contact me or those businesses as appropriate if you have any further questions.

Yours faithfully,



**RUPERT STEELE**  
Director of Regulation

## **Additional comments submitted on behalf of SP Energy Networks**

### **Chapter 1 Introduction**

No additional comment.

### **Chapter 2 Implications of EU Unbundling Requirements**

*OFTO of last resort* – We believe this role can probably remain with the generator, based on our understanding of the third package. The directing of a small OFTO to become the OFTO of last resort for a large offshore project could impose a very significant burden on such an OFTO. Ofgem should carefully consider the criteria for selecting the ‘directed’ OFTO.

### **Chapter 3 Regulatory Regime**

We believe that a competitively tendered regime can be successfully implemented, and that ScottishPower is well placed to be an OFTO, however we remain convinced that the proposals for dealing with adjustments to the revenue stream will provide an asymmetry of risk that makes the regime less attractive and will force any diligent OFTO take appropriate action to mitigate that will inevitably increase the charges imposed on generator and consumers.

An area requiring careful consideration is how the regime can effectively deal with Round 3 connections and allow infrastructure associated with an entire development zone to be constructed by a single OFTO. This infrastructure could be strategically developed in an economic and efficient manner with a mechanism allowing for adjustments to the revenue stream that reflect the extent of investment efficiently completed; we have provided more detail in our earlier responses.

In summary, a number of important aspects of the offshore regime, including details of how the availability incentive will work, remain unclear or appear to inappropriately load risk onto the OFTO. We look forward to an opportunity to discuss with you our outstanding concerns.

On specific points:

*End of the Revenue Stream* – 3.27 states that the one of the criteria for the extension of the revenue stream being considered is that the OFTO *wanted to continue its role*. There is however no further expansion on what would happen should the OFTO not wish to continue its role. We seek further detail on this matter.

*Adjustments to the revenue stream* –

*Unknown unknowns* – we continue to have grave concerns about the handling of exceptional events. We do not believe these events will be insurable at reasonable cost; in fact the effectiveness of insurance for such events may only be tested when an actual event occurs. A licensee will have little confidence that an unpredictable event will be covered by insurance or will trigger a re-opener as part of the regulatory regime, and as a result will be forced to make a decision on the level of risk mitigation required. The result is a high risk venture for an OFTO that will have an inevitable impact on the revenue stream and the associated cost to consumers/generators.

We remain of the view that an effective solution would be to trigger a re-opening when reasonably procured insurance products prove ineffective or prohibitively expensive. This should be explicitly provided for in OFTO licences.

### *Known Unknowns –*

*Indexation* – By minimising an OFTO's exposure to the cost fluctuations associated with inflation, full indexation will provide the OFTO with a stable real rate of return (other things being equal), thereby reducing risk and ultimately cost.

*Refinancing* – It is not evident that the OFTO will utilise project finance, so it may be difficult to distinguish refinancing gains. Even if they were readily identified, the proposed approach to sharing the benefits of re-financing is not reflected elsewhere in the regime where the OFTO is exposed to all of the risk. Given that clawback of refinancing gains would be likely to lead to higher initial bids, we are not convinced that the complexity is worthwhile.

*Incremental Capacity Increases* – The cap based on 20% of the original expenditure would seem reasonable. We would seek clarity on how the additional costs will be recovered by the OFTO.

*Other volatile and unpredictable costs* – We continue to believe that insurance premiums should be regarded as known unknowns due to the potential volatility in what brokers' advice is a high risk market. It is currently very difficult to predict premiums where the spread of insurance is restricted to offshore transmission assets.

*Delivery Incentives* – We would support the view that an OFTO has sufficient incentive to deliver the offshore transmission in order to commence the revenue stream.

*Operational Incentives* – We find the view of taken Ofgem and the view taken by the insurance industry completely opposed when considering the risk associated with offshore transmission cables. We are advised that an OFTO can expect expensive, volatile premiums for offshore cables; this is at odds with Ofgem's view that the regime should be driven by a very high availability baseline. We believe that citing only Moyle and Basslink as evidence of power cable reliability does not give a sound basis for a spread of possibilities. There is insufficient data to make a valid judgment on the reliability of these cables, in this environment and setting an availability target of 98% is unreasonable. We would support the setting of targets on a project by project basis.

The infancy of the industry and the lack of a wide range of statistical data is illustrated by the further analysis carried out by SEDG<sup>1</sup>. The significant changes to the underlying assumptions used for the GBSQSS work illustrates how difficult it is to secure relevant historical data. It is difficult for an OFTO to contemplate such high availabilities and measure the associated risk when there is insufficient historical data.

We see merit in the banking/permit mechanism but clearly this must be measured against realistic target availabilities. We are concerned at the possibility of multi-year penalties arising where an OFTO incurs a significant outage or series of outages in one year. More clarity is also needed on the detailed working of the mechanism, for example on the treatment of paying off of debit permits over a number of years. Care should be taken that a scheme does not deter an OFTO from taking maintenance outages and consideration should be given to excluding reasonable maintenance outages from the mechanism.

As with the availability target we feel strongly that the exposure to a penalty of up to 10% of allowed revenue is unreasonable in this new environment. This will encourage the OFTO to build in risk premiums, increasing the costs to generators and consumers.

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<sup>1</sup> The Centre for Sustainable Electricity and Distributed Generation

The operational incentives expose an OFTO to unnecessary risks. This is particularly relevant for transitional projects where the OFTO has had no control of the quality of the cable and platform design and installation.

*Construction Securities* – If construction securities are provided primarily to enable Ofgem to re-run the tender process then securities of 15% of high value construction costs will result in securities significantly in excess of those required, thus exposing OFTOs to unnecessary costs. The value of security should be set as part of the tender package and should be a pre-estimate of the cost of the activities that are being secured, namely re-tendering costs.

## **Chapter 4 – Standard Industry Framework**

See comments on Annexes below

## **Chapter 5 – Charging**

No comments as OFTO.

## **Comments on Annexes to Policy Update**

### **Consolidated Transmission Licence**

The narrative on pages 3 and 4 of annex 1 does not give any detail on why a number of changes previously put forward have been withdrawn.

Output measures (B17) – we think that further thought is required here before applying a condition geared to the long established onshore transmission networks in an offshore environment. It is not clear to us this condition should apply offshore.

Condition B18 (Offshore Transmission Owner of Last Resort) – discussion is needed with existing Transmission Owners (TOs) if onshore TO are to be required to take responsibility for offshore electricity transmission networks.

Condition E17 (offers for connection). It is unclear why a reference to the BETTA go-live date is required. Also, paragraph 1 sets out a requirement to be met prior to the licence condition coming into force, which is inappropriate. That requirement should be met prior to the licence being awarded by the Authority.

Condition E21 (offshore transmission owner of last resort). Paragraph 3 refers to the Authority considering that the direction would not significantly prejudice the licensee's ability to continue its existing activities. The meaning of "significantly prejudicing" is unclear. We would expect greater clarity on where an OFTO may be obliged to take on another network.

### **Grid Code**

OC8 – We were pleased to see the removal of OC8C & D and the modifications made to OC8A & B. We are currently reviewing the changes and will advise any comments at the earliest opportunity.

## **GBSQSS**

We note the 7.8.3.1 would appear to require double busbar switchboard arrangements at 33kV. Due to the physical arrangement of switches at 33kV is little benefit in double busbars and this should either be acknowledged or arrangements made within 7.21 for the OFTO to offer a design variation.

## **Special Licence Conditions**

We are disappointed that no draft special conditions for OFTOs have yet been published, as this was expected by September 2008. The draft NGET special conditions appear to accommodate such matters as pass-through of charges paid by the GBSO to offshore licensees.

**Additional comments submitted on behalf of ScottishPower Energy Management Ltd, ScottishPower Generation Ltd and ScottishPower Renewable Energy Ltd.**

**Chapter 2**

**We seek respondents' views as to our revised approach to the OFTO of last resort mechanism.**

We think that further consideration of the unbundling position is needed before deciding whether it is necessary to implement the scheme described here. In considering the appointment of an OFTO of last resort, Ofgem should have regard to the financial capability of small OFTO's to successfully deliver the transmission infrastructure to some of the larger scale offshore developments.

**Chapter 3**

**Extending or re-tendering licences at the end of the 20 year revenue stream – what are your views on the proposed options?**

At the end of the initial licence period, the OFTO should be permitted to bid a further regulatory revenue stream for the remaining life of the connection assets. If this is acceptable to both the generator and the Authority then no tender process should be required. This would avoid both the unnecessary expense of a re-tender process and the uncertainty to the generator over the ongoing operation of the offshore transmission assets.

The proposed 20% (of capital cost) threshold for an increase in transmission capacity represents a reasonable limit beyond which there should be bilateral negotiation between the generator and OFTO on any incremental investment required and the associated revenue stream. A re-tender for the future offshore transmission revenue stream should only be required if the OFTO and generator are unable to reach agreement.

**Indexation and adjustment of the revenue stream – do you have comments on our proposals in respect of:**

**Inflation?**

We agree that it would be appropriate to index the full revenue stream to the Retail Price Index. This provides certainty and predictability to both the generator and OFTO and provides the option to the generator to hedge cost increases using an appropriate financial instrument. It would also reduce the requirement for the OFTO to build in a risk premium, thus lowering costs to the generator / consumer.

**Refinancing?**

We question how easy it will be in practice to identify benefits achieved from future re-financing of offshore transmission assets, especially where such assets are built on balance sheet. Even if a mechanism is satisfactorily developed, it is questionable whether it will achieve much as it could simply be reflected in higher bids.

**Business rates and licence fees?**

As both of these items are outwith the control of the OFTO, we accept that any change in these costs should be passed through to the generator



**Any others?**

At this stage it is difficult to determine which risks will be insurable for both offshore generators and transmission owners and whether a sufficient number of insurance providers will emerge to create a market for insuring offshore asset risks. We would therefore suggest that where it can be demonstrated that insurance premiums have been competitively negotiated that these costs should be passed through to the generator.

**What are your views about a possible delivery incentive for onshore TO/DNOs?**

We support the view that due to the anticipated profile of expenditure on offshore assets that there is sufficient incentive on the OFTO for timely delivery in order to trigger the commencement of the revenue stream.

**Can our detailed proposal on the availability incentive be further refined and improved?**

As stated in our response to the regulatory policy update in February 2008 we believe that generic availability incentives may not be appropriate to each unique offshore connection and that bilateral negotiation between the generator and OFTO may deliver a more appropriate allocation of risk and reward between the parties.

We believe that performance incentives should be based upon a high availability target to reflect the requirement for access to be made available when the generator is able to operate and that the figure of 98% would be appropriate. However, there should be an incentive for performance by the OFTO above this level together with penalties for poorer performance. We agree that incentives should be set on a rolling basis which would enable OFTOs to “bank” high performance against future underperformance thus smoothing revenue flows for the OFTO but incentives should still provide sufficient compensation in a period of underperformance to protect generator cash flow. The rolling periods set should be reflective of the anticipated procurement / replacement / repair times for major items of offshore infrastructure.

We are concerned that the requirement for a “performance bond” towards the end of the revenue stream may precipitate the abandonment of offshore assets following a period of under performance by the OFTO. On the assumption that each OFTO will develop a portfolio of offshore assets, licence revocation procedures may provide sufficient incentive to maintain the assets over their remaining life.

**How should Ofgem appropriately respond to persistent poor performance by an OFTO, and how should any revocation mechanism be designed?**

The conditions which would lead to revocation of an OFTO licence should be clearly stated within the licence. The procedures should take an incremental approach which allows for dialogue between Ofgem, the OFTO and the offshore generator and allow sufficient time for remedial action to be taken before revocation occurs.

**What are your views on our proposal to manage the risk of OFTO abandonment through the OFTO of last resort scheme?**

Use of the proposed new OFTO of last resort scheme to mitigate the risk of OFTO abandonment is dependent on attracting sufficient number of parties into the OFTO role. In considering the appointment of an OFTO of last resort, Ofgem should have regard to the financial capability of small OFTO's to successfully fund, construct and operate the transmission infrastructure of some of the larger scale offshore developments.



The use of construction securities (of between 15 and 30 percent of construction costs) to mitigate the risk of abandonment during construction would act as a disincentive to potential investors. In the event of abandoned construction, Ofgem would be required to re-run the tender process to procure a new OFTO and the securities required should be reflective of the costs of this process. Requiring excessive securities during the heavy cash outflow of the construction programme would exacerbate the financial pressures on potential OFTOs – and therefore the costs paid by generators – and potentially increase the risk of abandonment.