Offshore Transmission
Policy Update
November 2008

Introduction and Summary

SP Energy Networks (SPEN) welcomes the latest policy update and the detail it brings to a number of areas.

The following points are in response to the request for comments of a material nature by 18 December 2008. This policy update and associated annexes bring a huge amount of information and we will provide a more comprehensive response by 9 January.

We are concerned about the uncertainty relating to the ability of vertically integrated companies having the scope to participate in offshore transmission, as implied by current draft EU legislation. While we understand and accept that OFTOs must be fully independent from generation interests, this can be achieved without full ownership unbundling being required. It is far from clear whether the provisions in the current draft directive to replace 2003/54/EC would allow an integrated company to establish an OFTO, even where the onshore arrangements were considered to provide sufficient independence of transmission from generation and supply activities. It is important that Ofgem and DECC exert their considerable influence to support continuation of the current arrangements for transmission in Scotland and for these to be extended to allow participation in Offshore Transmission. Without this the offshore transmission regime will lose two of the potential competitors.

We have the core competencies and resources available to participate in offshore transmission as an OFTO however the asymmetric risk profile, lack of clarity on re-openers and the availability penalty mechanism does not make the ownership of offshore transmission assets an attractive proposition and causes us to seriously consider our position.

Many of the specific comments echo our views on earlier consultations.

Specific Comments

Chapter 1 Introduction

We welcome Ofgem's acknowledgement of the importance of a coordinated approach for Round 3. We believe however that the regime as it stands will not achieve this. It is essential that a single OFTO develops a network for each Round 3 development zone. An overall infrastructure should be designed for a particular zone that could be developed on an appropriately phased basis, as we detailed in our last response we do not believe that leaving it to generators to make coordinated applications will deliver an economic and efficient solution.

For the very significant export capacities suggested in Round 3 to be delivered a strategic view of the overall infrastructure must be established. 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 a pragmatic approach to facilitation of strategic investment in development zones.

Chapter 2 Implications of EU Unbundling Requirements

We believe that the requirements in the latest revision of the EU Directive may in theory allow the Scottish model of an existing vertically integrated company to continue. It is however not at all clear whether it would be deemed acceptable for Scottish TOs to be able to participate, whether directly or indirectly in Offshore Transmission. The Scottish TOs have much to offer the regime as competition for bidding for licences or in support of the OFTO of last resort proposals.

DECC and Ofgem have the opportunity to exert influence on this process and we would ask them to support the extension of the Scottish situation as robustly as possible.

OFTO of last resort – 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

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 minimizing 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 – The 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. The sharing of benefits should reflect in a sharing of risk.

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[1]. 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

[1] The Centre for Sustainable Electricity and Distributed Generation

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.

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

We will comment in the January response.