

Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ

Offshore Transmission Team
The Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Tel: 01738 456107

Fax: 01738 456415

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Offshore Electricity Transmission A Further Joint Ofgem / DECC Regulatory Policy Update

Scottish and Southern Energy (SSE) welcomes the publication of Ofgem / DECC's further policy update on the regulatory regime for offshore electricity transmission.

The three themes of this further policy update are the implications of European Union (EU) unbundling requirements, the design of the regulatory regime and transmission charging. We respond on these topics below. Our comments on the proposed code and licence drafting are set out in annexes to this letter.

Implications of European Union unbundling

SSE is broadly supportive of the Third Package of legislation of the internal EU energy market to regulate gas and electricity markets.

The current drafting of the Third Package provides a mechanism for all three existing GB transmission licensees to continue in their same legal form after implementation of the directive. It is our understanding that these elements will remain broadly unchanged in the final directive and our response is based on this assumption. It is also assumed that National Grid, SP Transmission (SPT) and Scottish Hydro Electric Transmission Limited (SHETL) will be approved as Transmission System Operators (TSOs) compliant with the directive.

On this basis, there is no obstacle as a result of the Third Package to any of the existing GB transmission owners becoming offshore transmission asset owners (OFTOs). This is a prerequisite for the proposed inclusion of an 'OFTO of Last Resort' obligation into the GB transmission licence. The provision for an OFTO of Last Resort is, in our opinion, a necessity for

those transitional projects that will be built yet will not be able to operate without the appointment of a transmission owner and also in the event of abandonment by the OFTO either during construction or operation.

The Third Package of energy legislation recognises the importance of the Independent System Operator (ISO) to a transparent and non-discriminatory electricity market. We agree, and consequently support the proposals for enhanced separation between the functions of National Grid as GB System Operator (GBSO) and as a prospective OFTO. Such separation is necessary because of the role of National Grid GBSO in the proposed tender process.

We do question, however, whether the changes to the proposed structure of the GB transmission licence are the most effective and efficient way to distinguish between the roles and obligations of the GBSO, onshore transmission owners and OFTOs. Going forward, in light of both the OFTO regime and the Third Package, we believe there is a strong case developing for clearly separating the transmission licence into transmission owner and ISO functions.

Currently, the standard conditions of the transmission licence has four sections:

- Section A (definitions and application) that applies to all licensees;
- Section B (general) that applies to all licensees;
- Section C (obligations for a combined GBSO and transmission owner) that applies to National Grid; and
- Section D (transmission owner obligations) that applies to SPT and SHETL.

As set out in this consultation document, the standard conditions of the transmission licence would be revised as follows:

- Section A (definitions and application) that applies to all licensees;
- Section B (general) that applies to National Grid, SPT and SHETL;
- Section C (obligations for a combined GBSO and transmission owner) that applies to National Grid;
- Section D (transmission owner obligations) that applies to SPT and SHETL; and
- Section E (OFTO obligations) that applies to future offshore transmission asset owners.

We believe that this approach has the potential to be very confusing both in the first instance and as the regulatory regime evolves. An alternative, in our opinion simpler, approach would be to retain the four section licence but make each section relate to a specific function:

- Section A (definitions and application) that applies to all licensees;
- Section B (GBSO obligations) that applies to National Grid;
- Section C (onshore transmission owner obligations) that applies to National Grid, SPT and SHETL; and

- Section D (OFTO obligations) that applies to future offshore transmission asset owners.

Separating the transmission owner and ISO functions would mean a set of licence conditions for the transmission owners (National Grid, SPT, SHETL, OFTOs) distinct from the conditions for the ISO (National Grid). Hence, there would be clear separation of business functions.

Under this approach, consistent with the provisions of the Third Package, a licensee with Section B “switched on” would not be able to also have Section E “switched on”. However, licensees would be able to have Section C and D “switched on”. This would allow transmission owners to develop their systems under a single licence rather than, as proposed, requiring a separate licence for non-contiguous parts of the network.

Finally, we note that the current drafting of the Third Package requires that all undertakings owning transmission systems are designated as TSOs and are approved by Member States and the Commission. A further requirement is that all TSOs are required to join the European Network of Transmission System Operators (ENTSO). This will create an additional administrative barrier to entry for prospective transmission licensees, and we believe that Ofgem and DECC should consider measures to minimise this barrier. As we describe above, one option would be to allow TSOs to work under a single licence rather than requiring separate licences for each tender award.

Design of the regulatory regime

The proposals for the design of the regulatory regime are now well advanced and, hence, we concentrate here on new proposals in three areas where we believe that further policy development is required.

It is proposed in this document that Ofgem would require parties entering the tender process to bid a **revenue stream** that has a flat profile. While we understand the reasoning behind this proposal, we are concerned that this might limit the scope of prospective OFTOs to reflect the costs of their business. Furthermore, in seeking to “aid a more competitive tender process” this requirement might promote ‘price comparison’ rather than ‘best value’ in the bid assessment process. We strongly believe that the lowest cost bid is not necessarily the best bid and, from the perspective of the generation user, other factors (such as maintenance programmes, the holding of strategic spares, fault procedures) are equally, if not more, important. For this reason, we also believe that it is absolutely critical that the offshore generator is involved in the tender process.

It remains our view that without provisions to adjust the regulated revenue stream, OFTOs would face higher risk premiums and this would result in higher overall costs to the generator and GB consumer. We believe that provision for such adjustments should be made on a case by case basis with bidders for an OFTO licence being required to identify areas of uncertainty and propose mechanisms for addressing these. Similarly, Ofgem should be required to identify

those circumstances where it would seek to adjust the regulated revenue stream. Provision for adjustments should be agreed during the tender process and then set out in the licence.

The consultation document provides further detail on Ofgem / DECC's proposals for **performance incentives**.

We support Ofgem / DECC's 'minded to' position that there should be no specific delivery incentive on the OFTO. We agree that such an incentive is not required given the contingency of an OFTO's revenue stream on the completion of construction. However, we do not agree that onshore transmission owners and Distribution Network Owners (DNOs) should be subject to a liquidated damages provision in the event of delays in the delivery of onshore network reinforcements. There is currently no such provision in the industry codes given the wide range of largely exogenous factors that can result in delays in onshore reinforcement, for example the granting of planning consent. Moreover, such provisions are unnecessary given that network owners are incentivised to ensure efficient and timely delivery of capital investments through their price control settlements.

In relation to Ofgem / DECC's proposals for OFTO operational incentives, we support the principle of a rolling performance incentive that recognises the irregularity of fault conditions.

When seeking to determine an OFTO's target availability and exposure of revenues we believe that a basket of performance measures should be used allowing a number of factors to be taken into account. For example, an OFTO who seeks to minimise the unavailability of their assets by actions such as active maintenance and emergency vessel contracts would be assessed as having a high overall level of performance and consequently could be exposed to lower penalties than asset owners who have not taken such actions. This would allow prospective OFTOs to balance the costs of enhanced operational measures against a reduction in exposure of revenues through the operational incentive.

The consultation document includes new proposals in relation to the provision of **financial security**. It is proposed that the OFTO provide security of 15-30% of the expected construction costs to meet the costs of the offshore construction works in the event of abandonment during construction. Post-construction, it is proposed that the GBSO provide financial security to OFTOs to cover late payment for transmission services. Both of these financial security provisions would apply to OFTOs only. Both appear unnecessary as they imply a weakness in the regulatory regime that does not currently exist and, based on Ofgem / DECC's view of the OFTO regime, is unlikely to exist in the future.

Transmission charging

A clear framework for charging, access and compensation is absolutely critical for any offshore generator. Generators require clarity and certainty over the terms for access to the system, the costs of connecting to and using the system, and compensation arrangements in the event of

poor performance or unavailability of the system. While progress is being made on the framework for transmission charging, access and compensation, it remains our view that further work in this area is required as a matter of urgency.

We note that National Grid submitted its Conclusions Report on amendment proposal GB ECM-08 (For the introduction of charging arrangements associated with offshore transmission networks) to the Authority on 30 December 2008. While this is a welcome step forward in providing information to offshore generators on the cost of the using the GB transmission system, in our view the proposed modification would result in undue discrimination between onshore and offshore generation users. We continue to believe that the uncertainty and instability of transmission network use of system charges are a significant obstacle to investment in new generation in GB.

The vexed question of compensation in the event of network unavailability remains. Based on paragraph 4.30 of the consultation document, we interpret the following. For the onshore transmission system, the existing so-called CAP048 compensation arrangements will apply. For the offshore transmission system, a year-end assessment will take place. If the OFTO meets its operational incentive target, then no compensation payment will be made. If the OFTO does not meet its operational incentive target, then the generation user would receive compensation capped at the level of the OFTO penalty payment. The amount of compensation will be determined in accordance with the CAP048 compensation arrangements.

The CAP048 compensation arrangements do not apply to generation users that have less than full redundancy connection designs. Hence, for offshore generation users with a zero redundancy transmission connection, even if the OFTO breaches its operational incentive target, then no compensation payment will be made. This means that any penalty levied on the OFTO would be socialised amongst all system users.

We would welcome clarification of our interpretation of the compensation arrangements and, in particular, that offshore generation users with a zero redundancy transmission connection would not receive compensation.

Please do not hesitate to get in touch if you would like to discuss the issues raised in our response further.

Yours sincerely,

Aileen McLeod
Regulation Analyst

Annex 1 Proposed transmission licence drafting

We note and welcome Ofgem / DECC's intention to progress an overall review of the consistency of the proposed changes. Consequently, we do not comment below on drafting or consistency errors. However, we look forward to being able to provide, in response to the final consultation, final detailed comment on the proposed changes before the Secretary of State directs changes to the transmission licence.

The proposed changes to the transmission licence are significant and raise questions over future governance procedures. For example, would collective licence modifications to, say, Section B that arise from a price control be subject to approval by only those licensees with Section B "switched on" or by all transmission licensees. We would welcome clarification from Ofgem on the governance of future licence modifications.

Standard conditions

Section A

We agree that Condition A1 will need to be amended to include new definitions; and agree that no changes are required to Conditions A2, A3 and A4. We also support the proposed insertion of new Conditions A5 and A6.

Section B

We agree that the minor changes proposed for Conditions B4, B11 and B18 are required. We support the inclusion of new Condition B18.

Section C

We agree that the minor changes proposed for Condition C1, C9, C15 and C17, and new Condition C25 are required. We support the change to Condition C2 that prohibits the GBSO from seeking to hold or holding a transmission licence with Section E in effect.

With regards to the changes proposed for Condition C8, in paragraph 9 we believe that the duration "[X] months" should read "3 months".

With regards to the changes proposed for Condition C17, we note that the version of the GB Security and Quality of Supply Standard (SQSS) is likely to be amended as a result of a number of reviews currently underway; hence, we question whether it would be appropriate to refer, instead of to a version number, to a document 'as amended'.

Section D

As with our comments above on proposed modifications to Condition C17, we note that the version of the GB SQSS is likely to be amended as a result of a number of reviews currently

underway; hence, we question whether it would be appropriate to refer in Condition D3 to a document 'as amended'.

We agree that the minor change proposed for Condition D4A is required.

Section E

We agree with the proposed structure of Section E, and (subject to our comments below) the proposed conditions.

We note Ofgem / DECC's intention, as set out in paragraph 3.101 of the consultation document, to require OFTOs to comply with the same regulatory reporting requirements as onshore transmission owners. However, no licence conditions equivalent to Conditions B15, B16 or B17 are included in Section E. We would welcome clarification of whether or not such conditions will be proposed in the final consultation.

We support the shorter form Condition E13 (when compared with Condition B12) that recognises the proposed new governance arrangements for the System Operator – Transmission Owner Code (STC). However, we believe that Condition E13 should also make reference to the "applicable STC objectives", and oblige the OFTO to not act in a manner contrary to those objectives.

As with our comments above on proposed modifications to Conditions C17 and D3, we note that the version of the GB SQSS is likely to be amended as a result of a number of reviews currently underway; hence, we question whether it would be appropriate to refer in Condition E16 to a document 'as amended'.

National Grid's Special Conditions

We support the proposed amendments to National Grid's Special Conditions that would be needed to recover revenues to be passed on to OFTOs, to facilitate the implementation of the proposed OFTO of last resort mechanism and extend the geographical scope of the GBSO function.

We note that, with regard to facilitating the implementation of the proposed OFTO of last resort mechanism, similar provisions will require to be included in the special conditions of the other transmission owners (SPT, SHETL and future OFTOs).

The provisions of proposed new Special Conditions C1, C2 and C3 are critical to maintaining confidence in the independence of the GBSO. We agree that the proposed drafting provides for adequate business separation. We note that Special Condition C1 should also refer to 'any other STC Party'.

Annex 2 Proposed code drafting

We note and welcome Ofgem / DECC's intention to progress an overall review of the consistency of the proposed changes. Consequently, we do not comment below on drafting or consistency errors. However, we look forward to being able to provide, in response to the final consultation, final detailed comment on the proposed changes before the Secretary of State directs changes to the relevant documents.

In our response to the June 2008 policy document, we noted that the definition of *Force Majeure* might require to be revised in light of the particular characteristics of offshore transmission assets, the operating environment and the potential materiality (through the performance incentive) of events resulting in network unavailability. We support, as far as is possible, a common definition of *Force Majeure* across the licence and industry codes.

Balancing and Settlement Code (BSC)

We have no objection to the proposed changes to the BSC.

We note that the metering arrangements (section K) are unusual in that it is National Grid as GBSO that is responsible for metering when an offshore transmission network is connected to a DNO network. We understand that the Working Group concluded that this would be the best way to do this; however, this might be an area for review in the future.

Connection and Use of System Code (CUSC)

Subject to our comments below, we have no objection to the proposed changes to the CUSC.

- Section 2, clause 2.13.10 would give the GBSO the right to terminate the Bilateral Connection Agreement in the event that the Authority notified it that it was not progressing the tender process. We believe that this provision is unnecessary as the design of the regulatory regime is such that Ofgem / DECC do believe that such a situation will arise.
- Interdependency with the tender process: the proposed changes to the CUSC have cognisance of the requirement to modify bilateral agreements following the appointment of the OFTO. Such modifications should be reasonable and the user should retain the right to refer these agreements to Ofgem (for example, see clause 1.2.3 of the draft Offshore Construction Agreement). Further, where the GBSO is given the right to terminate agreements in relation to the tender process, this should only be as a result of actions within the users control.
- Treatment of restrictions on availability: the proposed changes to the CUSC include new section 2.13.7 that allows for the inclusion of 'clause 10' provisions within the bilateral connection agreement. These provisions can only be developed after the OFTO has been appointed and the final network design agreed. This means that these provisions will be

introduced as a modification to the bilateral agreement; hence, again, it is important that such modifications should be reasonable and the user should retain the right to refer these agreements to Ofgem.

Distribution Connection and Use of System Agreement (DCUSA)

Subject to our comments below, we have no objection to the proposed changes to the DCUSA.

- We agree that the limitation of liability areas might require further work. As described above, we are opposed to the proposed introduction of a liquidated damages provision in the event of delays in the delivery of onshore network reinforcements.
- We question the application of the guaranteed standards to this area given that it is not possible that any vulnerable customers will be connected to offshore transmission systems.
- In section 2B, clause 37.1.1 we would query why it should not be a Conditions Precedent that the “OTSO Party” holds a transmission licence.

Although not included here, going forward we believe it might be necessary for the DNOs to establish a contractual interface with generation users whose output has a technical impact on their system.

Distribution Code (DCode)

We have no objection to the proposed changes to the DCode.

Grid Code (GCode)

We have no objection to the proposed changes to the GCode.

System Operator – Transmission Owner Code (STC)

Subject to our comments below, we have no objection to the proposed changes to the STC.

- We agree that the revised governance arrangements appear to strike a balance between providing appropriate representation and the efficient governance of the code. However, we believe that these arrangements might need to be reviewed as the OFTO regime develops.
- We are opposed to the proposed introduction of a liquidated damages provision in the event of delays in the delivery of onshore network reinforcements.
- We believe the proposed amendments in relation to the provision of financial security (from the OFTO for construction costs and from the GBSO to cover late payment for transmission services) are unnecessary.

GB Security and Quality of Supply Standard (SQSS)

We have no objection to the proposed changes to the GB SQSS.