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Dear Colleague,

Connecting the Scottish Islands: Western Isles decision - 20/09

In September 2008, Ofgem published an open letter (the 'September 2008 letter')¹ in response to a request from Scottish Hydro-Electric Transmission Limited ('SHELTL') to modify its price control allowance to enable it to fund the investment in proposed connections to the Western Isles and Shetland.

The September 2008 letter discussed a number of developments relevant to our consideration of the issue of connecting the Scottish Islands. It set out and sought comments on the Authority's view that it is appropriate to consult on modifying SHELTL's price control allowance to establish an appropriate level of funding for the Western Isles connection. The September 2008 letter also noted that we intended to give further consideration to whether it was legally possible for SHELTL (or another provider) to be licensed to take forward a connection outside territorial waters before making a decision on SHELTL's request for funding for the proposed Shetland connection.

This letter discusses views raised in response to the September 2008 letter, confirms the view set out in that letter in respect of funding for the Western Isles connection and sets out next steps.

Background

The September 2008 letter discussed Ofgem's consideration of Scottish Island connections in the context of the last Transmission Price Control Review ('TPCR') and highlighted the issues raised and comments made in our June 2007 open letter ('the June 2007 open letter')². The June 2007 open letter outlined our high level thinking on options available for regulating transmission connections to the islands of Scotland, including the potential to develop a competitive approach.

The September 2008 letter also discussed the following developments since TPCR and our June 2007 open letter:

¹http://www.ofgem.gov.uk/Networks/Trans/ScottishIslands/Documents1/080916_OpenletterWIdecision_LN%20FINAL.pdf

²<http://www.ofgem.gov.uk/Networks/Trans/ScottishIslands/Documents1/Connecting%20the%20Islands%20of%20Scotland.pdf>

- **SHETL's March 2008 request for a price control reopener** to enable it to fund the investment in proposed connections to the Western Isles and Shetland.
- The work by Ofgem and government to develop the detailed framework to support **the competitive regime for offshore transmission**.
- Responses to our June 2007 open letter and our further thinking on the **practicalities of developing and implementing a competitive approach** for the proposed Scottish Island connections. We noted that we considered 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.
- Our view that SHETL's proposed connections should be delivered under the current regulatory framework. We explained that we consider there is merit in developing **strong incentive arrangements** to ensure that value for money is maximised for the consumer, consistent with what we have said in the context of the Transmission Access Review ('TAR').
- Our consideration of the **geographic extent of the legislative prohibition** and the transmission licence, and our view that 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 noted we were giving further legal consideration to this issue.

We set out in the September 2008 letter that we remain committed in principle to using a competitive process for significant new transmission investment wherever practical and in circumstances where the scope for cost savings outweigh the costs and the risks associated with a competitive approach. However, in light of the issues discussed in that letter and summarised above, including the potential for the adoption of a competitive approach to unduly delay the connection of generation, we set out our view that 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.

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

Respondents' views

We received seven responses to the September 2008 letter. These are available on our website³ and are summarised below.

The majority of respondents supported our proposed approach in respect of the Western Isles link, many considering it to be a pragmatic approach whilst emphasising the need for effective cost scrutiny by Ofgem. Two respondents stated that they preferred a competitive approach in principle, but accepted that SHETL should proceed with the Western Isles link in light of the practical issues around delivering a competitive framework in this case.

In its response, NGET (as GB system operator) stated that it is important to strike a balance between meeting the developer's requirements for timely connections and the interests of customers who should not pay any more than is necessary for the connection to be built. NGET considered that the reopening of SHETL's price control and the development of an appropriate incentive mechanism to fund the proposed connection works will ensure that SHETL have incentives to select an appropriate design and then build, operate and finance it efficiently.

NGET doubted the benefits of a competitive approach for delivering this connection. It considered that the costs of even a one year delay or the one-off costs of establishing a process that addresses the specific circumstances in this case, could easily outweigh even

³<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=38&refer=Networks/Trans/ScottishIslands>

the most favourable outcomes from a competitive approach in terms of cost of capital. Another respondent commented that it did not agree that a competitive tendering approach would help strategic planning needed to achieve the government's 2020 targets.

Some respondents were concerned with the likely cost of the Western Isles connection, considering SHETL had either over or underestimated the costs. One considered that SHETL has overestimated the required capacity, and considered it is premature for Ofgem to consult on funding given uncertainties at this stage. This respondent was concerned about the potential for unnecessary costs to fall to consumers. The respondent considered that wind farms in the Western Isles are a much higher cost compared to wind farms on the mainland in the north of Scotland and there is no reason for consumers to bear costs of electricity in a high cost location. This respondent stated that whilst it considered that the best way forward for a Western Isles connection is a modified *status quo* approach with SHETL shouldering some of the risk, it also considered there should be no firm commitment to the construction of *any* new link for the Western Isles until the appropriate capacity for the link can be established with reasonable precision.

Two respondents commented on the transmission charging arrangements. One considered that (beyond planning), regulatory uncertainty and transmission charges remain the biggest hurdle for island generators. The other considered that the lack of clarity around what use of system charges would apply was having a 'chilling' effect on investment in the islands.

Several respondents commented on the need to resolve the licensing uncertainty and for the Authority to make a decision in respect of funding for the proposed Shetland link.

Ofgem's views

We welcome the support for our approach to funding the Western Isles connection. We note that some respondents supported this approach whilst still preferring a competitive approach in principle. We also note that one respondent considered the benefits associated with a competitive approach (in terms of cost of capital) were unlikely to outweigh the risks in this case, and another respondent considered that this was not the best way to deliver 2020 targets.

As we set out in our September 2008 letter, we remain committed to a competitive approach for significant new transmission investment wherever possible, and we continue to consider that there is scope for this to be used where the benefits outweigh any potential risks. The benefits associated with a competitive approach would be expected to be wider than cost of capital, including amongst other things lower investment, encouraging innovation. We consider that a competitive approach could apply to the investment necessary to deliver the infrastructure required to support the delivery of the government's targets for connecting renewable generation beyond 2020. We also continue to consider it could apply to Scottish Island connections (including potentially the Western Isles) should the benefits of such an approach outweigh any potential risks. However, based on the information currently available to us, we remain concerned that there is a risk of delay in connecting generation associated with developing a competitive approach for the Western Isles connection. We therefore consider it is appropriate to enable SHETL to proceed with this proposed connection. However, this does not preclude us from forming a different conclusion should the costs or timescales proposed by SHETL, or any other relevant issue that we become aware of in the course of our consideration of this proposed connection, give us reason to do so.

We note that one respondent considered there was insufficient certainty at this stage to agree any funding for the Western Isles link; this respondent was concerned that unnecessary costs would fall to consumers. We fully agree that it is important to ensure that consumers do not face unnecessary costs. We anticipate consulting on the appropriate level of funding when we have further information from SHETL in terms of the detail of the proposed design, costs and timescales. SHETL's proposals will be carefully scrutinised by

Ofgem. In addition, we will ensure that appropriate incentives arrangements are in place to ensure that an appropriate proportion of the risks of stranding are borne by SHETL. We expect to consider this as part of the work we plan to take forward later in 2009 to develop new transmission owner incentives arrangements more generally⁴.

We note that one respondent considers transmission charging remains a hurdle for island generators. As noted by this respondent the issue of transmission charging is outwith the scope of this consultation. Another respondent was concerned at the lack of clarity on what use of system charges would apply to island connections. We would encourage developers to engage with NGET to get an indication of how the existing charging methodology would apply to island connections. We anticipate that NGET will be in a position to provide a firmer indication of likely charges when SHETL's proposals are more fully developed and when there is greater certainty in terms of any impacts on charging arising as a consequence of any of the changes to the enduring access arrangements being developed by industry and considered by Ofgem.

We note a number of respondents commented on the need to resolve the licensing uncertainty in respect of the Shetland link. We will write separately on this matter when we have had an opportunity to consider further legal advice.

Way Forward

We intend to consult on modifying SHETL's price control allowance to establish an appropriate level of funding for the Western Isles connection. We expect to initiate this consultation when we have more detailed information from SHETL on the design, timescales and cost of the proposed connection. We will also consult on whether it is appropriate to develop the new incentives arrangements to apply to the funding for the Western Isles connection. We currently anticipate the consultation will be issued in the second half of 2009.

We are giving further consideration to the appropriate way forward for the proposed Shetland connection and will write separately on this matter in due course.

Yours sincerely,



Stuart Cook
Director, Transmission

⁴<http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/tar/Documents1/090227TOShortTerm%20Measures.pdf>