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Dear Cheryl

Transmission Access Review – Enhanced transmission investment incentives: update and consultation on further measures

Scottish Hydro Electric Transmission Limited (SHETL) continues to strongly support Ofgem's work to identify and assess transmission investments which will reduce or remove existing grid-related barriers to the connection of new generation. We agree that the regulatory framework must strike a balance between ensuring that efficient investment is delivered on time and protecting customers and licensees from disproportionate risk. We are committed to working with Ofgem and the other transmission licensees to progress such changes to the framework that are necessary to achieve this.

Signalled investment and anticipatory investment

The consultation document rightly distinguishes between the two key drivers for investment in new transmission capacity. The first key driver is a *known demand* from users which is measured through contractual undertakings ("signalled investment"). The second key driver is an *expected demand* from users which can be anticipated from, for example, wider national policy objectives ("anticipated investment"). The consultation document notes that the risk associated with these different investment drivers is very different, and suggests that regulated funded arrangements should reflect this difference.

Signalled investment is ‘business as usual’. Users signal their need for transmission capacity and contract with the National Electricity Transmission System Operator (NETSO) for access to that capacity. The NETSO separately signals this need to the relevant Transmission Owner (TO) and, where required, the TO invests in the network. It was based on this approach that the existing regulatory framework was agreed at Transmission Price Control Review (TPCR) 4.

We continue to believe that the TPCR4 settlement is robust for the period to 2012 and can accommodate the large transmission investments that have now been identified as a result of users’ needs. Importantly, the deep revenue driver mechanism represents an appropriate balance between ensuring that efficient investment is delivered on time and protecting customers from disproportionate risk. We recognise that the licence drafting of the deep revenue driver is complex and might need to be modified to ensure that the mechanism is fully effective; we have previously suggested a number of such drafting changes.

As the consultation document notes, SHETL has already made submissions to the Authority under the provisions of the deep revenue driver mechanism for transmission investment projects Knocknagael and Beauly-Blackhillock-Kintore (BBK). As described in those submissions, these investments are signalled investments and, as such, it remains our view that the deep revenue driver mechanism represents the most appropriate means of allowing regulatory funding. Of the other projects nominated by SHETL for commencement before or during 2010/11, Beauly-Dounreay and Kintyre-Hunterston are also signalled investments and, hence, we believe should be progressed through the deep revenue driver mechanism.

Anticipatory investment is investing ahead of signalled need. The Transmission Access Review (TAR) identified that it typically takes much longer to deliver new transmission capacity than new generation developments. In addition, transmission capacity is “chunky” and there are significant economies of scale in “building big” even if this means investing before known need. As a consequence, it was recognised that there is merit in the TOs progressing anticipatory investments; particularly given the Government’s 2020 targets.

The main risk associated with anticipatory investment is that the transmission capacity is not ultimately required, i.e. there is a risk of asset stranding. Such a conclusion can generally only be reached many years after the investment has been made. However, it is a key tenet of network regulation that investment decisions should only be assessed against the information that is available at the time the decision is made. At that time, the assessment of stranding risk for potential anticipatory investments is a complex calculation that must take into account a range of factors including future demand and generation scenarios, the current condition and performance of the network, the proposed technical solutions and incremental cost of new capacity, available resource and the supplier market, and planning and environmental considerations.

In principle, risk should be allocated to the party best able to control and manage that risk. For the stranding risk associated with anticipatory investment, it is not clear that there is a single party who has control of the risk. Ultimately, the use of capacity depends on the actions of future, as yet unknown, users. The costs and benefits of providing that capacity currently accrue to consumers who pay for capacity now to avoid future higher investment costs and realise the benefit of greater market competition. Yet the decision to make that anticipatory investment rests with the NETSO and TOs based on an assessment of future need against the cost of potential reinforcement options. While it could be argued that the NETSO and TOs should be exposed to some of the risk arising from the quality of their analysis, it is not credible to argue that they can control or manage that risk.

Given this, it is our view that a generic funding arrangement for anticipatory investments that retains an appropriate balance of risk and reward for TOs, the NETSO and customers is very difficult to achieve. We have given this issue substantial consideration over recent months and our view is greatly informed by analysis of the potential anticipatory investments nominated by SHETL; each of which has its own risk profile, contingent generation and demand users, and engineering solutions. Given this, we support bespoke funding arrangements for the small number of projects that builds upon the existing deep revenue driver mechanism. Such an approach has the benefit of allowing for specific engagement with all of the main stakeholders in the proposed transmission reinforcement.

Potentially anticipatory investments nominated by SHETL for commencement before or during 2010/11 are the Western Isles link and the Shetland link (including, subject to the outcome of a funding request to the EU, the offshore hub). The potential stranding risk associated with these investments depends, in large part, on the status of affected generation users at the time the investment decision is taken.

Pre-construction expenditure

Although SHETL did not put forward proposals for additional pre-construction expenditure in 2009-10, we fully supported the regulatory funding mechanism that was developed by Ofgem earlier this year. We continue to believe that, where there is a demonstrable need, pre-construction funding should be allowed to ensure that large transmission investment projects are advanced in a timely manner. Consequently, we support the provision of further allowances for 2010-11 using the existing $RevApOx_t$ licence term.

Way forward

In its information request of 13 August 2009, Ofgem specifically sought information on projects for which construction funding will be required before or during 2010-11. In our response, we identified six projects, for two of which SHETL has already committed construction expenditure given the strong needs case underwritten by contracted users (through the NETSO). Consequently, we strongly support the proposed accelerated licence change proposal set out in the consultation document.

For transmission investment projects Knocknagael, BBK, Beauly-Dounreay and Kintyre-Hunterston which, as we described above, are signalled investment, we believe that the accelerated licence change proposal should seek to modify the existing deep revenue driver mechanism. For transmission investment projects Western Isles and Shetland, we recognise that there might be an element of anticipatory investment and, as a consequence, we have work to do to understand the risks and costs/benefits of the proposed reinforcements. We have begun work on these issues, including discussions with the main stakeholders, and would hope to meet with you to discuss this in the near future.

We note the two options proposed in the consultation document that might align the work on enhanced transmission investment incentives with the RPI-X@20 project. While we recognise the potential overlap between the two workstreams, we would be extremely concerned if a consequence of achieving alignment was to delay decisions in relation to those projects for which construction funding will be required before or during 2010-11. Hence, regrettably, we do not support either of the two options proposed.

I hope these comments are helpful. Please do not hesitate to get in touch if you wish to discuss any aspect of this response further.

Yours sincerely,

Aileen McLeod
Regulation Analyst