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RESPONSE FROM STATKRAFT TO HIGH LEVEL PRINCIPLES ON CONNECTION ISSUES

To whom it may concern,

Please find enclosed Statkraft's response to connection issues discussed in your letter from 22 March 2011.

If you have any queries please do get in touch.

Yours sincerely,



Bjørn Drangsholt
Managing Director, Statkraft UK Ltd.

Ofgem Project TransmiT consultation: Next step on connection issues: High level principles

Consultation response from Statkraft

1. Introduction

Our current experience is that the system for charging for grid connections could act as a barrier for the deployment of offshore wind in the UK. Offshore wind development is financially risky and very capital intensive, and the costs are heavily front-loaded. Large security requirements on the top of that imply a risk of offshore development plans schemes being withdrawn or reduced.

There should be an appropriate balance of risk between consumers, network companies (distributors as well as National Grid) and developers. Both sides of the market, generators and suppliers (including their customers), have a key interest in the low-carbon transition taking place—both in terms of achievement of decarbonising generation and enhancing security of supply. Both sides should therefore contribute proportionately to underwriting the associated cost and risks, including the high level of infrastructure development needed to accommodate changing patterns of generation deployment.

In addressing risk allocation the arrangements needs to take into account the fact not all forms of generation give rise to the same level or types of risk. Offshore wind developers in particular have already made significant financial commitment to their projects through entering into development agreements with the Crown Estate, before entering into discussions with TOs. For such projects, once the relevant consents have been obtained the risk of cancellation reduces. Once a financial investment decision has been made the risk of cancellation is very small indeed. In order to avoid excessive security requirements only development work by NGET and not capital expenditure should be guaranteed ahead of the wind-farm project reaching a Financial Investment Decision (FID).

2. Key principles and required changes

Statkraft has welcomed the recent change to the calculation of Final Sum Liabilities (FSLs) based solely on local works. However, it is clear that further significant change is needed.

Statkraft also supports the review process underway on Connection and Use of System Code (CUSC) Modification Proposal CMP192, including the need to codify rules and expose them to CUSC governance. It is essential however, that developers' legitimate concerns are recognised as part of this process. If a solution that is truly enduring is to be reached, it is essential that the review of user commitment is not simply an exercise to transcribe the interim FSL, hybrid and Interim Generic User Commitment Methodology (IGUCM) approaches into the CUSC.

We have identified some key issues flowing from the current user commitment arrangements and the related defects. These are:

- timing issues and trigger points – no securities for capital expenditure before FID
- treatment of wider works
- choice of methodology
- transparency and accuracy of value at risk (VAR) at any time
- securitisation requirement should reflect that cancellation risk for a project is reduced over time
- capping of liabilities
- scope for asset reuse.

We will recommend the following principles to be applied in the enduring regime for connections:

a. Timing issues and trigger points – no securities for capital expenditure before FID

Any development which requires transmission investment will need close liaison between the developer and the transmission owners. However under the current arrangements the transmission investment programme appears to operate almost in isolation of the developer's programme. Once TOs have identified the works that are required their investment and building programme proceeds on the basis of meeting commissioning dates. No account is taken of a developer's programme or perceived risk profiles.

Trigger points for transmission investment, and associated calls for securitisation, need to reflect the project and investment timescales of the developer. While Statkraft believes the current generic costs arrangements for pre-trigger stages should remain, the first trigger point for security should be the generator consent date (Trigger1) as this is the first point at which the project can be considered with any certainty. Before FID (Trigger 2) only development work and not capital expenditure should be guaranteed. The TO should let its construction programme be triggered by an aligned Financial Investment Decision point (FID) of the generation project and TO first reinforcement FID.

Trigger points for transmission investment, and associated calls for securitisation, need to reflect the project and investment timescales of both the developer and the TOs. Before an aligned FID point for the generation project and the TO's first reinforcement only development work and not capital expenditure should be secured.

b. Wider works vs. local works

Network reinforcement generally benefits the wider community of grid users (suppliers and demand), and so it would be appropriate for the TOs to share to a greater extent the risk associated with them. In particular it is not appropriate to load costs and risks of underwriting wider grid infrastructure onto the generation project developers as can occur at present under IGUCM (and which used to apply to FSL). Offshore wind development is already financially risky and very capital intensive, and the costs are heavily front-loaded.

The TOs have previously expressed concern that excluding the costs of wider works from security requirements could encourage speculative applications and hence inefficient investments. **However the reality is that in the majority of cases the magnitude of liabilities for local/enabling works (especially those associated with offshore developments) would be more than sufficient to deter such applications and can of itself delay/deter legitimate investment.**

The current regulatory approach already gives NGET what we believe is a high level of protection to recover its investment costs as assets will be included into its regulatory asset base (RAB) irrespective of their utilisation. Opportunities for undertaking wider works ahead of user commitment can be an efficient and cost-effective approach, where need is recognised to exist. Ofgem's allowance of capital spend by the TOs ahead of user commitment for the TIRG works is an example of how such a situation can be managed in practice.

c. Choice of methodology: FSL vs IGUCM

All developers should be free to choose between the FSL methodology and the generic IGUCM methodology. The IGUCM methodology should also be available for offshore works. Offshore developers should face the same choices as all other developers. Different project technologies are likely to face different timing issues and considerations. It should be for the developer to determine which of the two securitisation routes suits it best.

Developers should be able to choose between generic (IGUCM) or specific (FSL) approaches for all elements of the works. Where a developer has elected IGUCM for onshore works, this option needs to be preserved under any new regime.

d. Transparency and accuracy of value at risk (VAR) at any time

Levels of security requirements relate to the TO's initial estimate of costs. On that basis a developer is required to determine whether or not to follow IGUCM or FSL. Under FSL National Grid will provide six-monthly updates of liability. Experience would suggest that National Grid appears to err on the side of caution when estimating costs and assessing VAR for securitisation. For the Doggerbank project Creyke Beck connection, indicative costs had in February 2011 dropped to only a small fraction of the level in March 2010. It is thus quite reasonable to suppose that some schemes may have been withdrawn before signing connection agreements because of overly high initial cost and security estimates.

It is therefore imperative that a developer has an accurate and timely indication of the value at risk requiring securitisation. Whilst it is recognised that some degree of caution may be appropriate, it is imperative that costs are updated (and security requirements revised) as soon as more accurate estimates become known.

There are a number of instances under GB network regulation where incentive schemes have been applied to licensees to improve the accuracy of their forecasting. Consideration should be given to how such arrangements might be applied to the calculation of security levels under IGUCM and FSL.

For cost reflective processes, cost estimates need to be accurate and updated on a timely basis. Some form of incentives (or penalty) upon the TO to provide accurate information may be appropriate.

e. Securitisation requirement should reflect that cancellation risk for a project is reduced over time

Both with FSL and IGUCM cancellation security requirements increase significantly towards commissioning date. Under IGUCM the level of security increases annually after the TO trigger date by 25% increments until it reaches 100% the year ahead of commissioning. This reflects the increasing investment requirements by the grid owner. In parallel however, the prospects of cancellation diminish rapidly due to the increased financial and commercial commitment to the project from the developer. The cancellation security requirement should take this reduction in cancellation risk duly into account. In its proposals presented to CMP 192 National Grid is considering the application of 'likelihood' factors that would reflect this.

Security requirements should be reduced as the probability of scheme completion increases. For the enduring IGUCM this principle could be reflected in the percentage of the TNUoS multiple sought up to a predetermined cap. For FSL the quantum of liabilities could be reviewable annually.

f. Capped liabilities in the IGUCM model

IGUCM security is based on multiples of TNUoS charges. The cost of reinforcement works bear no relationship to existing TNUoS tariffs. As the increased financial and commercial commitment to the project from the developer such basing the IGUCM calculation on a multiple of TNUoS rates that differ significantly between zones of itself is discriminatory, and should be reviewed. Security should always be proportionate even under a generic approach. TNUoS is a simple and easily applied mechanism, but security requirements should be based on an average rate and not a zonal one. As noted above, the reduction in cancellation risk over time should also be taken into account. The liabilities should hence be capped at a proportionate level.

An alternative approach may be to consider is adopting the policy used in Germany where generators of 100MW or more have to provide generally non-refundable security of €1,000/MW, which is a more benign application of user commitment ahead of the pre-trigger period.

We suggest a minimum requirement for FSL in such circumstances equal to two times the prevailing average generation wider use of system tariff would be appropriate and consistent with the commitment that existing generators presently pay for exiting the system.

g. Scope for asset reuse

No allowance is made by NGET under IGUCM or interim FSL of the scope for asset reuse in the event of project cancellation. It has carried out some work that suggests that up to 15% of scheme costs can be recovered by asset reuse. This assessment looks very conservative, and focuses only assets being scrapped and materials being reutilised. It takes no account of the possibility that the works are quite likely to be utilised for related or other future developments. If some schemes fail, others will take their place.

Risk assessments should be applied to the likelihood of abortive works arising so that only the highest risk portion is allocated and secured. This should also make specific allowance for the scope of asset reuse or other projects adopting the works.

3. Sum up of Statkraft's recommendations

We will sum up our recommendation for an enduring connection regime as follows:

- only development work and not capital expenditure should be guaranteed ahead of the wind-farm project reaching a Financial Investment Decision (FID).
- security requirements should only relate to enabling works; and not include wider works
- developers should have the options of FSL or a modified enduring general user commitment methodology

For the cost reflective Final Sums Liability mechanism (FSL) mechanism:

- Cost estimates need to be accurate and updated on a timely basis;
- Securitisation of capital expenditure should be triggered by an aligned FID of generation project and TO first reinforcement FID (Trigger 2).
- The methodology should incorporate a cancellation probability factor related to project stages;
 1. the first trigger date (Trigger1) for reducing security based on a cancellation probability factor should be the developer consent date or the TO consent date whichever is the later, and not the point at which the TO obtains the necessary consents;
 2. the second trigger date (Trigger 2) for reducing security based on a (lower) cancellation probability factor should be an aligned FID of generation project and TO first reinforcement FID;

- consideration should be given by the CMP 192 working group to varying the percentage of security reduction by scheme technology, which can be justified around project experience to date;
- some allowance, perhaps a 20% reduction should be made to the assessed liability amount to reflect the scope for asset reuse.

For the generic mechanism (IGUCM):

- initial costs (including TO development costs, studies etc. the process should continue to be securitised on a fixed, predictable profile. Current policy should continue at £1/kW, £2/kW etc. up to the current £3/kW cap until the trigger date; the security requirements should only relate to enabling or local work;
- the process should then allow for one trigger point;
- the trigger point for reducing security based on a probability factor should be an aligned FID of generation project and TO first reinforcement;
- Security under the generic mechanism after the trigger point should be based on the higher of the pre-trigger liability or a multiplier of say two times¹ national average (not zonal) TNUoS to reflect the reduced cancellation likelihood and asset reuse potential;
- consideration should be given by the CMP 192 working group to varying this multiplier by scheme technology, which can be justified around project experience to date;
- change of the assessed liability costs should be triggered by an aligned FID of generation project and TO first reinforcement FID (Trigger 2).