

Final decision on Scottish Hydro Electric Transmission Limited's ("SHTL") application for an Article 9(9) derogation¹ from full ownership unbundling and certification on this ground

This document sets out the final decision on SHTL's compliance with the requirements of the Third Package² for transmission system operators ("TSOs") to unbundle from generation, production and supply undertakings as implemented into the domestic legislation in Great Britain ("GB").

1. The Applicant

SHTL holds an electricity transmission licence in respect of the electricity transmission system in northern Scotland, which it owns and maintains. Consequently, SHTL is a TSO within the meaning of Article 2(4) of the Electricity Directive and has applied for certification on the grounds of a derogation from full ownership unbundling under Article 9(9) of the Electricity Directive and for designation as a TSO under the Third Package under Article 10(2) of the Electricity Directive.

2. Certification Decision

2.1. The certification ground pursuant to which SHTL applied for certification is on the basis of a derogation from full ownership unbundling under Article 9(9) of the Electricity Directive. In compliance with the European Commission's ("the Commission's") decision in relation to our preliminary certification decision and analysis on SHTL, Ofgem³ concludes that SHTL complies with the requirements set out in Article 9(9) of the Electricity Directive and in section 10E(4) of the Electricity Act and should therefore be granted a derogation and consequently certification on this ground and should be designated as a TSO. In this regard, we consider that on 3 September 2009 SHTL's arrangements guaranteed more effective independence of SHTL than the provisions of the independent transmission operator ("ITO") model set out in Chapter V of the Electricity Directive.

¹ The applicant applied for an exemption from the ownership unbundling requirement under section 10E(4) of the Electricity Act 1989, to which we refer in this document as the "derogation" from full ownership unbundling.

² The term "Third Package" refers to Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC ("Electricity Directive"); Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003 ("Electricity Regulation"); Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC ("Gas Directive"); Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 ("Gas Regulation"); and Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators.

³ Ofgem is the Office of the Gas and Electricity Markets Authority, which supports the Gas and Electricity Markets Authority, the regulator of the gas and electricity industries in Great Britain. The terms "Ofgem" and the "Authority" are used interchangeably in this document.

3. GB Legislation – Transposition of the Electricity Directive

3.1. In GB the ownership unbundling requirements set out in the Electricity Directive have been transposed through the Electricity and Gas (Internal Markets) Regulations 2011 ("the GB Regulations") which insert new sections 10A to 10O into the Electricity Act 1989 ("the Electricity Act").

3.2. SHETL applied for certification pursuant to section 10E (4) of the Electricity Act which provides that the applicant can ask the Authority to exempt it from the ownership unbundling requirement on the grounds in paragraph (9) of Article 9 of the Electricity Directive (alternative arrangements for independence), if the Authority thinks the requirements of that paragraph are met.

3.3. The test for the exemption from full ownership unbundling set out in Article 9(9) of the Electricity Directive is as follows:

- as at 3 September 2009, the transmission system in question belonged to a vertically integrated undertaking ("VIU"); and,
- as at 3 September 2009, there are arrangements in place which guarantee more effective independence of the TSO than the provisions of Chapter V ("the ITO model") of the Electricity Directive.

3.4. Ofgem's preliminary decision was that SHETL meets the test set out in Article 9(9) of the Electricity Directive and should be granted a derogation and consequently certification on the ground set out in section 10E (4) of the Electricity Act and should be designated as a TSO under section 10H2 of the Electricity Act. In this regard, Ofgem considered that, when considered alongside the role of National Grid Electricity Transmission plc ("NGET"), as an ownership unbundled and independent system operator ("SO"), and in the context of the GB regulatory arrangements where the Authority has extensive powers within a competitive market, SHETL's arrangements as at 3 September 2009 guaranteed more effective independence of SHETL than the provisions of the ITO model⁴. A summary of Ofgem's preliminary decision analysis is below:

- The arrangements in GB provide for an ownership unbundled SO (NGET) which has a significant role in determining real-time operation and access to the network, thus removing the ability of SHETL to discriminate in favour of its VIU's generation or supply activities in terms of system operation. The arrangements prohibit SHETL from discriminating against any person in its offers for connection.
- SHETL is required to base its connection offers on the Construction Planning Assumptions provided by NGET and NGET is required to carry out an economic impact assessment on the options put forward. These arrangements allow NGET to have involvement in the information used by the transmission owner (SHETL) to produce their offers. Furthermore NGET's licence states that if NGET and the person seeking a connection fail to enter into a connection agreement after a reasonable length of time, the Authority can settle any terms in dispute of the agreement.
- The arrangements are governed by the Authority, which has the power to initiate enforcement action if SHETL does not comply with its extensive obligations. We also now have the power under sections 11A and 11B of the Electricity Act, as required

⁴ Set out in Chapter V of the Electricity Directive.

by Article 37 (4)(a) of the Electricity Directive, to make binding decisions on electricity undertakings by imposing licence modifications on licensees.

4. Commission decision

4.1. We note that in order to successfully obtain a derogation from the full ownership unbundling model and therefore certification on that ground, *"the Commission shall verify that the arrangements in place clearly guarantee more effective independence of the TSO than the provisions of Chapter V"*⁵ of the Electricity Directive and that in reaching a final certification decision the Authority *"shall comply with the Commission decision"*⁶.

4.2. This requirement has been implemented through section 10E(8)(c) of the Electricity Act which provides that regardless of whether a certification ground applies, the Authority must not decide to certify the applicant on the second certification ground set out in section 10E (4) of the Electricity Act (exemption from the ownership unbundling requirement on the grounds in paragraph (9) of Article 9 of the Electricity Directive (alternative arrangements for independence)) if the Commission has not verified, in accordance with paragraph (10) of Article 9 of the Electricity Directive (verification of independence under alternative arrangements), that the requirement in that paragraph as to arrangements for effective independence is met.

4.3. On 14 May 2012 the Commission issued a decision on the application of Article 9(9) of the Electricity Directive to SHETL. After considering Ofgem's preliminary certification decision and analysis on SHETL the Commission has concluded that the arrangements in place in relation to the vertical integration and operation of the transmission systems belonging to SHETL existing on 3 September 2009, meet the requirements of Article 9(9) of the Electricity Directive and guarantee more effective independence of the transmission system operator than the provisions of chapter V of the Electricity Directive. The Commission's opinion was therefore that certification should be granted to SHETL on this ground.

4.4. Ofgem therefore, in compliance with the decision of the Commission, exempts SHETL from the ownership unbundling requirement under section 10E(4) of the Electricity Act, pursuant to the test set out in Article 9(9) of the Electricity Directive and certifies SHETL on the ground set out in section 10E(4) of the Electricity Act.

4.5. In its decision the Commission noted that strengthening some individual elements of the Scottish arrangements would be welcomed. Specifically, the Commission drew attention to the cooling off periods (relating to restricting the transfer of management personnel from SHETL's transmission business to any affiliate or related undertaking), the criteria for assessing the independence of the compliance officer and ensuring that share ownership and group-wide bonus schemes that apply across the VIU are insignificant. In relation to these three points, Ofgem will monitor compliance with the unbundling provisions and if deemed necessary will seek to impose licence amendments to SHETL's transmission licence⁷. We note that the following provisions in SHETL's transmission licence currently provide for Ofgem's oversight in the current arrangements:

- With respect to the independence of the compliance officer, we note that Special Condition E(4) of SHETL's transmission licence requires that SHETL must consult with Ofgem before appointing a "competent person". Within this process there is scope for

⁵ Article 9(10) of the Electricity Directive

⁶ Article 3(6) of the Electricity Regulation

⁷ Under sections 11A and 11B of the Electricity Act

Ofgem to express dissatisfaction with a particular individual's suitability for the role of SHETL compliance officer, before any candidate can be appointed.

- On the cooling-off period relating to SHETL management personnel, we note that Special Condition D(8)(b) of SHETL's transmission licence specifies that the licence can and does prevent any person who has ceased to be engaged in, or in respect of, the activities of any other business of the licensee (or any affiliate or related undertaking of the licensee) until expiry of an appropriate time from the date on which he ceased to be engaged by SHETL. This allows Ofgem to determine the appropriate cooling off period on a case by case basis. We will expect SHETL to notify Ofgem of any expected transfer of relevant staff and of expected cooling off periods. Ofgem will take account of the Commission's comments on assessing the cooling off periods.
- More generally, Ofgem notes that upon certification the Authority will require SHETL to provide it with a written declaration by 31 July each year, setting out among other things:
 - Whether any event or circumstance has occurred in the previous 12 month period, or such part of that 12 month period since the certified person was certified, that may affect the certified person's eligibility for certification, and if so, the reasons it considers that the event or circumstance may affect its eligibility for certification;
 - Whether there have been any changes to the certified person's arrangements (including but not limited to the certified person's regulatory and legal arrangements) in the previous 12 month period or such part of that 12 month period since the certified person was certified that may affect how the Authority assesses that the certified person's arrangements guarantee more effective independence of the certified person than the provisions of Chapter V of the Electricity Directive.
 - Ofgem also notes that upon certification SHETL will be required to furnish the Authority with such information as the Authority may reasonably require, or as may be necessary, for the purpose of monitoring and review of the certification under section 10I of the Electricity Act;

4.6 These provisions allow for Ofgem to monitor the relevant SHETL arrangements, including share ownership and bonus schemes and take the appropriate remedial action if it deemed necessary.

4.7 Notwithstanding the above, the Commission concluded that: "In relation to investment decisions and connection approval, the central role of National Grid, as a fully ownership unbundled transmission system operator, brings a Great Britain wide approach to decisions in the carrying out of the transmission system operator role in Scotland. In relation to the limited tasks of Scottish transmission companies in transmission system operation, the possibility of bringing a dispute to Ofgem and the regulatory safeguards applying to the Scottish transmission companies provide strong guarantees of independence. Taken together these ensure that the Scottish arrangements deliver more effective independence than the independent transmission operator model in relation to investments and new connections."

4.8 Pursuant to Article 3(6) of the Electricity Regulation Ofgem will comply with the Commission's decision on the certification of SHETL.

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