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Dear Colleagues

Open Letter: Update on the Integrated Transmission Planning and Regulation Project – request for further views and evidence

Ofgem is inviting you to respond to any of the questions set out in this open letter or issues raised about the Integrated Transmission Planning and Regulation Project (ITPR). This call for views and evidence will be open until 14 December 2012.

ITPR is a proactive review of the network planning and delivery arrangements for electricity transmission. It is considering how our arrangements will facilitate a future integrated system for onshore and offshore transmission and interconnection. We launched the project with an open letter in March, setting out the drivers for ITPR and seeking stakeholder views¹.

Since then, we held an external workshop and a number of bilateral discussions with stakeholders to explore the project drivers and issues associated with facilitating an integrated network. From this engagement, we identified a number of potential issues that stakeholders believe may pose a barrier to facilitating an integrated network which can be grouped into four broad categories:

1. The obligations and incentives on the multiple parties involved in transmission network planning and delivery may not align to ensure that individual networks or assets develop in line with the overall needs of the system.
2. The framework for GB transmission entities to engage in European transmission activities may not provide an effective means for all relevant parties to contribute, giving rise to a risk that the GB system is insufficiently represented at the European level.
3. There is a potential for conflicts of interest for parties undertaking transmission planning and delivery.
4. The regime interfaces for transmission related multiple purpose projects² are potentially unclear, giving rise to a lack of clarity around regulatory treatment for these assets.

¹ The open letter, along with the responses, can be found at the following link: <http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/itpr/Pages/index.aspx>

² Transmission related multiple purpose projects could serve the combined purpose of connecting offshore generation, providing reinforcement of the onshore network and/or linking our market with that of other Member States.

Identification of these issues does not prejudice any subsequent policy direction; we are open to views on the materiality of these four issues, and we seek to validate (or rule out) issues on the basis of further evidence gained in response to this open letter. We also welcome stakeholders raising any further issues. This will inform our identification and initial assessment of potential options where necessary, with a view to consulting on any proposals next year.

We are aware that there are significant interactions between ITPR and other projects ongoing in Ofgem and externally, these are highlighted at the end of this letter. Whilst ITPR has a focus on longer term transmission integration issues, we are committed to ensure that we manage these project interactions carefully and maintain momentum on short term issues such as offshore coordination and interconnector investments.

For example, our existing offshore coordination and interconnector investment projects will continue to address the known issues in these areas, and will seek to provide timely conclusions in advance of proposals coming out of the ITPR project. In addition, and where appropriate during the course of the ITPR work, we will seek to accelerate “no-regrets” decisions related to integrated transmission planning and delivery.

Potential issues raised by stakeholders

Issue 1: The obligations and incentives on the multiple parties involved in transmission network planning and delivery may not align to ensure that individual networks or assets develop in line with the overall needs of the system.

The GB electricity transmission network is planned, built and operated by a number of different transmission entities, including the national electricity transmission system operator - the “NETSO” - (National Grid), onshore transmission owners (National Grid, Scottish Hydro Electricity Transmission plc and Scottish Power Transmission Limited), offshore transmission owners (OFTOs), generator-build OFTOs, and interconnector owners. There are also a number of parties exploring the possibility of developing multiple-purpose transmission projects. Reflecting the fact that all these parties are subject to different and separate regulatory regimes for onshore, offshore and cross-border assets, they are also subject to different processes, obligations and incentives. Stakeholders have given examples of how they believe this could impact efficient, integrated system development:

- All transmission entities can contribute to optimising the operational efficiency of the system in the short term, but the costs (and benefits) of various actions are often split between different parties.

Onshore transmission owners (TOs) and interconnector owners bear the operational costs of maintaining their own system, but are not directly exposed to the onshore constraint costs that may arise from the way in which they undertake short-term operational actions (e.g. planned maintenance).

Instead, the NETSO is responsible for managing these constraint costs, but conversely it does not see any of the operational costs of maintaining the network. Appropriate incentives exist between the TO in England and Wales and the NETSO as they are part of the same parent company (National Grid Electricity Transmission, NGET).

However, it has been argued that there are limited incentives between the NETSO and Scottish TOs or interconnector operators to undertake short-term operational planning,

such as maintenance, in such a way that helps all parties to optimise whole system costs and benefits efficiently³.

- The process for obtaining a connection to the onshore GB transmission system is user led and based on a “first come, first served” approach for assigning connections to system users. This has successfully mitigated the risk of asset stranding and provided increased certainty to those seeking a connection.

Some stakeholders have suggested that the current process for informal negotiations around connection arrangements works well and provides adequate flexibility to optimise and coordinate connections where needed. Others have suggested that this opportunity for informal negotiations is insufficient, and that the general approach restricts the transmission entities’ ability to plan the system efficiently. In particular, because they cannot always find opportunities to revise connection offers and propose coordination where it could result in a more economic and efficient outcome.

- The opportunities for establishing a holistic perspective of the long term needs of the system are limited. Although frameworks for cooperation between transmission entities exist, they have some limitations that may prevent a holistic and shared perspective from emerging, for example:
 - The System Operator-Transmission Owner (SO-TO) code (the STC): As well as setting out the terms of engagement, role and responsibilities for the SO and onshore and offshore TOs, the STC provides a useful forum for consideration of short-term operational issues between signatories. However, it does not typically consider longer-term investment or planning challenges and it does not currently involve interconnector operators, so the scope of its work and influence is restricted.
 - The Electricity Network Strategy Group (ENSG)⁴: ENSG has successfully provided a means for transmission entities to consider certain strategic issues associated with network development up to 2020. However, the initial scope of the ENSG was limited to identifying the necessary investment onshore and around the boundaries of the onshore network to accommodate the 2020 renewable energy targets. It did not consider offshore or cross border developments. Furthermore, not all OFTO and no interconnector operators are represented on the group.
 - The Electricity Ten Year Statement (ETYS): Some stakeholders highlighted the revision of the Seven Year Statement (SYS) and the Offshore Development Information Statement (ODIS), into the ETYS as a helpful step in developing a coordinated understanding of future network needs onshore and offshore. In particular the inclusive nature of the industry consultation that surrounds the development of the new Statement was seen as positive. However, the extension of the view into a comprehensive perspective cross border is still limited.
- There are limitations to the technical information that onshore and offshore TOs, interconnectors, developers of offshore generation and multiple purpose project developers have access to with respect to the overall GB system needs. This could include, for example, information around system harmonics.

³ To help address this, we are developing the Network Access Policy (NAP) under RIIIO-T1. It is designed to provide a framework for communication and cooperation around network planning and information between NETSO and the Scottish TOs.

⁴The ENSG is a high-level forum bringing together key stakeholders in electricity networks to support Government in meeting the long-term energy challenges of tackling climate change and ensuring secure, clean and affordable energy. These include network companies, generators, Trade Associations and Devolved Administrations. It is chaired jointly by representatives from the Department of Energy and Climate Change (DECC) and Ofgem.

Stakeholders suggested that this could mean that the development of individual parts of the network may not be consistent with wider system needs, particularly as coordination of transmission assets becomes more complex. However, there are also restrictions around what information the NETSO can share, particularly with commercial parties, given the confidential nature of the connection requests/offers.

- Under European legislation⁵, interconnector operators are recognised as transmission system operators (TSOs) and are treated as such in relevant areas of GB legislation (e.g. in relation to payment of transmission charges). However, interconnector operators are also signatories to the grid user codes (rather than the STC), which means they are also required to follow processes that are based on the needs of generation and demand.

Stakeholders noted that this suggests interconnector operators are subject to dual responsibilities and, potentially, a lack of clarity around which process to follow in some instances. Furthermore, while there are recognised cooperation mechanisms by which NGET interacts with its neighbouring TSOs on operational issues⁶, there is no explicit provision for all parties (i.e. the NETSO, the interconnector operator and the neighbouring TSO) to cooperate and identify the most economic and efficient approach to integration of additional cross border capacity into the two systems.

Questions

1. Do you think that the key issues, as described above, should be considered? What is the materiality of the issues identified?
2. Are there any other issues to be considered in this area?

Issue 2: The framework for GB transmission entities to engage in European transmission activities may not provide an effective means for all relevant parties to contribute, giving rise to a risk that the GB system is insufficiently represented at the European level.

Most Member States in Europe are characterised by having a single TSO responsible for all aspects of electricity transmission system planning and delivery. Every national TSO is then responsible for cooperating at the European level with other TSOs through the ENTSO-E⁷.

Amongst other responsibilities, the ENTSO-E is required to produce the European Ten Year Network Development Plan (TYNDP), which is designed to improve transparency around investment in electricity transmission required on a pan-European basis.

All national TSOs contribute to this process, reflecting their own national development plans and working with other TSOs on a regional basis to identify cross border capacity requirements and coordinated projects.

At present, NGET and the Scottish TOs contribute to the work of ENTSO-E. However, other transmission entities, so-called "third parties" such as OFTOs and interconnector operators,

⁵ 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.

⁶ For example, the IFA interconnector between GB and France allows for system operator to system operator cross-border balancing under the "BALIT" arrangements. There are also arrangements to provide for coordination around the forecast and operation of electricity flows across Europe through, for example, CORESO. (www.coreso.eu).

⁷ The European Network of Electricity Transmission System Operators (ENTSO-E) is the body responsible for facilitating cooperation among TSOs on issues associated with facilitating optimal management, coordinated operation and sound technical evolution of the European electricity transmission network. Its roles and responsibilities are set out in Article 4, of the Regulation (EC) No 714/2009.

have not been well represented in its work. Some stakeholders have suggested that, particularly with respect to the work around the TYNDP and identification of “projects of common interest” under the Energy Infrastructure Package, there is a need to ensure that third parties are appropriately represented.

Several stakeholders have noted the importance of having a common understanding of how the entire GB system may need to develop. In particular, to ensure that we identify appropriate opportunities for coordinated projects with other Member States and that we contribute appropriately to development of an integrated European network.

Questions

3. How effective are the current arrangements in representing all GB transmission entities’ interests within ENTSO-E?
4. How material is the impact of these arrangements on representation of the GB transmission system developments in the TYNDP and other related European activities?

Issue 3: There is a potential for conflicts of interest for parties undertaking transmission planning and delivery.

There are a number of regulated transmission entities that have a role in both transmission system planning (as discussed above) and other, competitive businesses engaged in delivery. National Grid, for example, has a number of different regulated and competitive business interests in GB including the NETSO; the TO in England and Wales; owner and operator of multiple interconnector projects⁸; and as a potential future offshore transmission owner. Similarly, the Scottish TOs are owned by parent companies that have generation and supply interests and, potentially in the future, interconnection.

Stakeholder responses to our March open letter highlighted the need to consider the effectiveness of the current business separation arrangements between TO monopoly businesses and TO competitive businesses. This has also been raised by some respondents to our July open letter on offshore coordination in relation to the NETSO’s and TOs’ potential involvement in pre-construction for some offshore assets⁹.

The mix of regulated and competitive businesses could create the potential for conflicts of interest within the parent company. We have sought to mitigate this by subjecting the monopoly companies to certain business separation arrangements, for example:

- Because of its role as NETSO, there are detailed separation arrangements in place between NGET and any party bidding for an OFTO licence. NGET has access to information (around the offshore generator’s connection request, for example) which could be advantageous to affiliated parties (such as National Grid Offshore Limited) in seeking to bid for an OFTO licence. As such, there are requirements around managerial and operational separation. National Grid’s business separation compliance officer is required to report on these arrangements on an annual basis¹⁰.
- For National Grid’s interconnector businesses, separation with NGET extends to the separation of regulatory accounts (financial separation) to reinforce the prohibitions on cross-subsidies and discrimination. Interconnection is also a separately licensed activity.

⁸ National Grid International Limited, a wholly owned subsidiary of National Grid plc, shares ownership and operation of the IFA interconnection with RTE, the French electricity TSO. It also has a joint venture with NLink International B.V. to own and operate Britned, the electricity interconnector connecting the electricity systems of GB and the Netherlands.

⁹ Responses will be available on www.ofgem.gov.uk shortly.

¹⁰ The Annual Compliance Report can be found on National Grid’s website.

- For the Scottish companies, provisions are in place in the transmission licence to ensure managerial and operational separation of the transmission businesses¹¹. These provisions are designed to ensure separation between the vertically integrated transmission and generation/supply businesses and extend to separation around staff, equipment and information and the provision for a compliance officer¹².

Despite these provisions, if the business separation arrangements are perceived as incomplete or ineffective in places, there is a risk that this could undermine investment. With respect to this issue, therefore, we welcome views on the questions set out below.

Questions

5. How effective are the current business separation arrangements the transmission entities are subject to?
6. How material is the impact of the current arrangements on efficient network development?
7. Where networks are increasingly integrated, are there other areas where the question of conflicts should be considered?

Issue 4: The regime interfaces for transmission related multiple purpose projects are potentially unclear, giving rise to a lack of clarity around regulatory treatment for these assets.

Hypothetical examples of multiple purpose projects were discussed in our March open letter. Stakeholders, particularly multiple purpose project developers, have suggested certain areas where there may be a lack of clarity, including around:

- The type of licence the asset operator should be awarded. Under the current arrangements, operators of onshore and offshore transmission assets must hold a transmission licence which differs for the NETSO, TOs and OFTOs¹³; interconnector operators must hold an interconnector licence. However, as multiple purpose projects could serve the combined function of connecting offshore generation, providing reinforcement of the onshore network and/or linking our market with that of other Member States, it is unclear in some cases which licensing regime may apply to certain assets. This gives rise to a general lack of clarity around which licensing regime(s) a multiple purpose project sits under.
- The regulatory treatment of multiple purpose projects. For example, the costs associated with constructing and operating transmission infrastructure are recovered in different ways for onshore transmission, offshore transmission and interconnection¹⁴. Furthermore, the duration of the revenue stream and the various incentives that impact the revenue stream (with respect to, for example, availability) differs according to the

¹¹ SHETL and SPTL have been granted derogations to allow them to operate their transmission and distribution businesses as single network businesses, subject to certain conditions.

¹² The Annual Compliance reports can be found on the Scottish Companies' websites.

¹³ NGET is subject to sections A (Interpretation, Application and Payments), B (General), C (System Operator Standard Conditions of the electricity transmission licence). The Scottish TOs are subject to sections A1-A4, B1-B14 and D1-D15 (Transmission Owner Standard Conditions). OFTOs are subject to sections A and E (Offshore Transmission Owner Standard Conditions).

¹⁴ For onshore transmission assets, NGET and the Scottish TOs recover their costs through an eight-year price control under the RIIO framework. There are also a number of flexibility mechanisms, such as the strategic wider works mechanism, to enable TOs to recover costs and manage uncertainty for projects required in the near-term. For offshore transmission assets, parties who have successfully won an offshore transmission licence receive a twenty year regulated revenue stream to own and operate the asset under the Generator Build model or construct, own and operate the asset under the OFTO build model. Interconnector operators, recover costs through auctioning capacity to the market.

regime under which a project is regulated. Stakeholders have suggested that these issues give rise to uncertainty around the regulatory treatment of multiple purpose projects.

- The charging arrangements for use of the assets. The Transmission Network Use of System (TNUoS) charges for onshore and offshore are designed to provide an annual, fixed *ex ante* charge for use of the network. Charges for use of an interconnector are established through the use of auctions and are therefore variable according to the market's valuation of the capacity. Stakeholders have suggested that this difference in approach could give rise to uncertainty around how charges for use of multiple purpose assets are determined.
- The access arrangements. Connection to the onshore electricity transmission system is offered based on the "connect and manage" approach¹⁵. Users then access the system under the terms of their connection agreement with the NETSO. For interconnection, third party access (to the interconnector) is guaranteed, but as highlighted above, capacity is offered to potential users through auctions. For multiple-purpose projects involving a cross-border element, stakeholders have suggested that it is unclear how access arrangements would work.

In addition, it has been argued that all of these issues could be further complicated by the fact that assets may develop sequentially and, therefore, take on the characteristics of multiple-purpose projects during the course of their lifetime.

Questions

8. Do you agree that these issues associated with multiple purpose projects should be considered? What is the impact of the issues you identify as relevant? In particular how do they affect multiple purpose projects?
9. Do the issues capture all the potential regulatory barriers? Are there any other issues to be considered in this area?

Next steps with respect to issues

We welcome views about the materiality of the issues outlined above, timing for addressing them and responses to the questions posed. As part of this, it would be helpful to have specific examples or case studies of where these issues arise. We would also appreciate stakeholders' feedback on whether the issues outlined above appropriately capture the areas that merit consideration as part of the ITPR project. Furthermore, we invite views around how the issues should be addressed, where you consider this necessary.

Interactions with other work areas

As mentioned earlier, the ITPR project has extensive interactions with other Ofgem work areas and several external projects. To help identify the boundaries of the ITPR work and to highlight critical dependencies between areas that we will take into account as the ITPR project progresses, we have elaborated on these interactions below.

Competition in transmission

As part of our strategy for RIIO, we stated that we would develop a framework to allow third parties to build, own and maintain parts of the onshore electricity transmission

¹⁵ Under the "Connect and Manage" approach, connections are offered based on the time needed to complete a project's enabling works rather than waiting for wider onshore reinforcement works to be complete.

system. We consulted twice on our initial thoughts on this framework in 2011¹⁶, and in April 2012¹⁷ we published an open letter stating that we were taking more time to consider the costs and benefits of implementing a competitive framework in onshore transmission.

We are now undertaking this work as part of the ITPR project. This will ensure that we take a coordinated approach to our examination of the costs and benefits of a potential extension to the use of competition, and our consideration of what is needed to deliver a future integrated transmission system under ITPR. Our findings will form part of our consultation on ITPR options next year.

Offshore coordination

The Offshore Coordination project seeks to remove barriers within the offshore regime that are making it difficult for offshore developers to take forward projects, in the short-term, with coordinated elements¹⁸. We will be consulting on our proposals later this year, which will focus on enabling changes to allow projects in the development stage to progress. The ITPR project will take a longer-term approach, considering the potential issues associated with longer-term development of integrated networks across onshore, offshore and interconnection.

Electricity Market Reform synergies and conflicts of interest

The government has indicated that the NETSO is the preferred delivery body for Electricity Market Reform (EMR). The Department of Energy and Climate Change (DECC) and Ofgem are considering the potential synergies and conflicts of interest that may arise from this wider role and a consultation is due to be published shortly on this subject. Although the ITPR project will focus on the system planning role of the NETSO and not the EMR delivery role specifically, where relevant we will consider the responses to the EMR consultation and the implications for options we may explore under ITPR.

Regulated investment regime for interconnection

Where they are economic and efficient, we are keen to facilitate nearer-term interconnector investment proposals. As part of this, we are continuing to develop a regulated interconnector investment regime, currently being piloted on the proposed GB-Belgium interconnector. While there are clear links between this work and ITPR, which we will seek to take account of as the policy in each area develops, we recognise that there may be potential interconnection projects that require regulatory decisions before final conclusions are reached on ITPR.

System Operator incentives 2013

We are currently consulting on our initial proposals for electricity System Operator incentives from 2013¹⁹. These proposals recognise that NGET's ability to control constraints that arise in non-NGET networks is limited. We propose, in addition to our proposals to move towards a broader incentive approach, that the management of constraint costs are taken forward as part of the Network Access Policy work under RIIO-T1. This is closely related to the issues under the ITPR project around the roles and responsibilities on transmission entities with respect to network planning, conclusions from the SO incentives work will feed in to ITPR activity.

¹⁶http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/111216_Consultation_Compensation.pdf

¹⁷<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Compupdate.pdf>

¹⁸http://www.ofgem.gov.uk/Networks/offtrans/pdc/cdr/2012/Documents1/201207_Coordination%20open%20letter%20Final.pdf

¹⁹ <http://www.ofgem.gov.uk/Markets/WhIMkts/EffSystemOps/SystOpIncent/Pages/SystOptIncent.aspx>

The North Seas Countries Offshore Grid Initiative (NSCOGI)

There are a number of issues associated with facilitating an integrated offshore grid across the North and Irish seas, which would connect wind generation and Member States. The NSCOGI provides a framework for regional cooperation among Member States (and Norway) and regulators around grid infrastructure developments in the North Seas. We are closely involved in this work to ensure that our contributions to discussions on the high-level principles for the regulation of integrated infrastructure in the North Seas are consistent with the work of the ITPR project.

Renewables Trading

We are liaising with DECC in relation to its ongoing work around considering the possibility of cross-border energy trading. A decision to allow generation located outside GB to avail of UK subsidies for renewable and/or low-carbon-generation is likely to be significant for the development of multiple purpose projects.

RenewableUK work on the potential for a design authority

In line with the recommendations of the Offshore Wind Task Force to Government, RenewableUK are leading work to explore the potential role for a design authority for offshore transmission. We understand this is also considering how such a concept could apply in the context of onshore and cross-border planning. We will consider the outputs from this work as we take forward our own analysis of potential options to address identified network planning issues.

Next Steps

The next phase of the ITPR project will involve the identification and assessment of potential options where necessary to address the issues outlined above, together with any additional issues that may come to light through responses to this open letter. These may range from smaller refinements of existing arrangements to bigger changes, depending on our understanding around the materiality of the issues, and are likely to focus on areas around system planning and connection processes, institutional arrangements and licensing. We intend to consult in spring 2013 on possible high-level options and our initial analysis of them. The consultation will provide the opportunity for further input into our consideration of both the issues and the potential solutions identified.

How to respond

If you wish to respond to the questions posed by this open letter or provide any other feedback on the issues set out in this letter **please respond to ITPRMailbox@ofgem.gov.uk by 14 December 2012**. We will publish responses to this letter on our website unless clearly marked as confidential.

We would also welcome discussions with interested parties on a bilateral basis. Please contact ITPRMailbox@ofgem.gov.uk if you would find this helpful.

Yours Faithfully,

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