

SSE comments on Ofgem's Open Letter: Update on the Integrated Transmission Planning and Regulation Project – request for further views and evidence

14th December 2012

SSE welcome Ofgem's request for further views and evidence related to the Integrated Transmission Planning and Regulation (ITPR) Project. We note Ofgem's acknowledgement that there are significant interactions between ITPR and other projects ongoing, led by Ofgem and externally, and we welcome Ofgem's commitment to manage these project interactions carefully.

We support Ofgem's first priority in progressing this review to provide regulatory certainty and maintain a stable investment environment for both transmission entities and system users.

A summary of our views on the Open Letter is as follows –

- Any review of the network planning and delivery arrangements for electricity transmission should be proportionate and needs-based.
- Given the potential scale and impact of the outcome of such a review, we expect that a full Regulatory Impact Assessment will be completed, by Ofgem, at the earliest opportunity.
- Any framework for greater coordination between transmission entities should be light-touch, collaborative and incentive-led. An instructive framework is not appropriate in this circumstance.
- A specific, defined framework for the development of multiple purpose projects is required. In the first instance, there should be two workstreams created to consider specific issues – one to consider system planning and delivery issues and another to consider user charging and access issues.
- The project should give consideration to the full regulation of interconnectors.
- The outcome of the ITPR project must not change the RIIO-T1 regulatory settlement. Any changes required must be implemented at the end of the current price control period.

Consideration of the issues set out in the Open Letter

We consider it important that any review of Integrated Transmission Planning and Regulation is proportionate, appropriately focussed and need-based. In determining the need for a review, we note Ofgem's assessment of four potential issues raised by stakeholders.

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.

We agree that this issue should be considered within the ITPR Project.

Statutory obligations

We consider that the most substantial reason for the misalignment in obligations and incentives of transmission entities is the arbitrary distinction between transmission entities as set out in the Electricity Act.

The Electricity Act determines that the three types of GB transmission entity (onshore TO, offshore TO and interconnector) are separate and distinct from one another and each may not participate in the area of activity of another. For example, an onshore TO may not participate in an offshore TO's area of activity. This distinction draws an arbitrary line between what is considered, across the rest of Europe, to be simply transmission infrastructure.

The current statutory obligations on transmission entities are clear but they are not the same for each type of transmission entity. The Electricity Act places obligations on onshore and offshore TOs to act in a coordinated manner. These obligations around coordination do not apply to interconnectors. While transmission entities are meeting their statutory obligations, this variance in obligations creates another distinction between transmission entities.

We consider that coordination between all three types of transmission entity is challenging while this artificial distinction, between what is fundamentally transmission infrastructure, persists. **We propose that the Electricity Act is amended to remove this distinction between transmission entities.**

Incentives

Incentives for transmission entities take two forms –

- a. Financial incentives (revenue recovery); and,
- b. Reputational incentives (transparency and reporting).

The Electricity Act definition of separate transmission entities is supported by differing investment and revenue recovery models for each type of transmission entity.

Onshore TOs are subject to an 8 year Price Control (which governs revenue recovery) and significant financial stability obligations, while offshore TOs are subject to a 20 year Price Control and interconnectors are funded by a merchant-investment model. The subsequent financial returns, and route for revenue recovery, for each type of transmission entity are quite diverse, driving different investment decisions and creating a range of investment environments.

Along with different investment models, the drivers for each transmission entity are also misaligned. While onshore TOs must consider a range of users which include both generators and consumers, offshore TOs are simply investing to connect specific offshore generators and interconnectors provide a rent-based service for market participants who may not even have a physical connection to the transmission system either end of the interconnector.

If multiple purpose projects develop such that offshore TOs serve a wider range of users, it is essential that the Price Control model that offshore TOs are subject to is aligned to that of the onshore TOs, thereby providing a more appropriate range of financial incentives and reporting requirements on the offshore TOs.

Furthermore, it is important that interconnectors are subject to similar financial incentives and reporting requirements so that their drivers are aligned with the onshore and offshore TOs. In order to achieve this, **we propose that extensive consideration is given to fully regulating interconnectors.**

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.

We do not agree that this is an issue and, hence, it does not need to be considered within the ITPR Project.

As a result of the Electricity Directive 2009, all certified TSOs have a right to participate in the activities of ENTSO-E. To date, this activity, from a GB perspective, has been led by National Grid as NETSO. However, each TSO may choose the scale of participation it would prefer.

Given this choice available to certified TSOs, we do not consider there is an issue to be resolved by the ITPR Project.

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

We agree that this issue should be considered within the ITPR Project. However, we disagree with the specific issues set out in Ofgem's Open Letter.

While it is true that the vertically integrated undertakings which have ownership of the onshore TO businesses also have competitive businesses within their group, there are stringent and robust business separation arrangements which ensure that no conflicts of interest arise. These long standing arrangements are subject to annual review and audit by a Compliance Officer and the outcome of the review communicated to Ofgem. Furthermore, these arrangements were recently subject to substantial scrutiny and underpin the Article 9(9) derogation granted by the European Commission to both Scottish TOs.

We consider that there is no issue with vertically integrated undertakings owning both TO and competitive businesses as the arrangements in place clearly and demonstrably prevent any conflict of interests.

While there are currently no business separation arrangements between TO and NETSO functions within the National Grid business, we consider that if, following the outcome of the ITPR Project, the NETSO is granted additional powers in relation to the coordination of TOs, there would be potential for a significant conflict of interests between National Grid's TO and NETSO business. We also consider that a conflict of interests is already possible between National Grid's TO and NETSO business as a result of the Electricity Market Review and the proposed additional duties of the NETSO (as referenced in the current Ofgem/DECC consultation).

We propose that, as a minimum, business separation obligations, akin to those already in place within the vertically integrated undertakings who have ownership of the onshore TOs, are implemented between National Grid's TO and NETSO businesses. These types of obligations have been proven to be effective in preventing conflicts of interest within vertically integrated undertakings and there is no requirement to un-bundle such businesses. However, the obligations should be included in the relevant licences to ensure that sufficient importance is placed upon them.

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.

We agree that this issue should be considered within the ITPR Project

We consider that this issue should be addressed specifically and separately from the issue of general coordination between transmission entities. A resolution to this issue will be required if multiple purpose projects are to develop in the future, and regulatory clarity is the most important factor in encouraging the development of such projects.

Regardless of how effective general coordination between transmission entities is, the lack of a specific regulatory framework for the treatment of multiple purpose projects is the most substantial barrier to progress in this area.

Given the level of investment required in the GB transmission system over the next decade, regulatory certainty is critical. It is essential that the investment environment is stable and predictable and that the treatment of multiple purpose projects is transparent and consistent. Ofgem acknowledged the importance of this in their previous Open Letter, published in Spring 2012, where they stated that an objective for the ITPR Project was to, "Ensure that the regimes continue to provide effective and stable frameworks for the significant investment in transmission infrastructure that is required in the future."

We do not consider it appropriate to determine the regulatory treatment of multiple purpose projects on a case-by-case basis, in lieu of underpinning regulation. This approach would not provide sufficient certainty for investors or developers and is likely to delay the delivery of infrastructure.

We propose that clear regulatory principles for the treatment of multiple purpose projects are established as a key output of the ITPR Project. These principles should provide –

- Clarity over the regulatory regime which will govern the delivery of the multiple purpose project – this may be a bespoke regime, developed to deal with a range of multiple purpose projects and connection scenarios;
- A clear process for the funding and determination of multiple purpose projects - this may be similar to the Strategic Wider Works funding process as set out in RIIO-T1 or aligned with the OFTO funding process;

- Consistency of the charging regime for the range of users of multiple purpose projects – this may have a significant impact on the existing TNUoS arrangements for both onshore and offshore generators;
- Transparent access arrangements for users of the multiple purpose project – this may include prioritisation of connection requests;
- Clarity over the regulatory treatment of anticipatory investment, including risk and cost apportionment;
- Alignment of the obligations of transmission entities.

It is important that any regulatory principles address potential discrimination between transmission entities in regard to their disparate obligations. For example, where onshore TOs must have regard for security of supply and the consumer, the interconnector licensee is not obliged in the same way. This variance in obligation naturally leads to a difference in investment perspective and should be addressed if the development of multiple purpose projects is to be successful.

We consider that simplifying the definition of transmission and removing the artificial distinction between transmission entities will help to ensure that any potential discrimination is avoided and that obligations are aligned. These changes are likely to require an amendment to primary legislation, in particular to the Electricity Act.

We propose that in order to fully consider the regime interfaces and issues around multiple purpose projects, two workstreams should be created - one to consider the coordination of the planning and delivery of the multiple purpose project and another to consider the impact on customers, specifically regarding access and charging.

The system planning workstream should use the existing JPC and ENSG arrangements as a starting point and focus on a collaborative, light-touch approach to coordination.

The access and charging workstream should focus on providing certainty around investment and address the allocation of anticipatory investment.

The outcome of these workstreams should then inform the design of a specific regulatory framework for the development, delivery and funding of multiple purpose projects.

Additional issues to be considered within the ITPR Project

In addition to the issues set out by Ofgem in their Open Letter, we propose that there are a number of other issues which should be taken into account at this stage.

1. Significant Code Review process

As stated in our response to the previous Open Letter, we consider that the potential impact of this project on the framework of the electricity industry is substantial. In light of this, we maintain that the ITPR project should be progressed within the Significant Code Review framework. In particular, we expect that a full Regulatory Impact Assessment will be completed the earliest opportunity.

2. Specific inclusion of charging and access arrangements in the ITPR Project

While charging and access arrangements have been mentioned as part of issue 4 in the Open Letter, we maintain that this area is an extremely important factor in the development of multiple purpose projects and it must not be considered to be outwith the scope of the ITPR Project. Although Project Transmit is in its final stages, the ITPR Project cuts across many of the issues considered within Project Transmit and it is essential to ensure that coordination between Transmit and ITPR exists.

3. Existing developments to transmission access arrangements

It should be noted that there are a number of existing, informal developments within the transmission access arena at present which should be included for consideration within the ITPR Project. In particular, the Connection Options Information Note (COIN) process and the move towards integrated offers for offshore generators.

The COIN process

The COIN process is an informal assessment of the connection options for offshore generators or OFTOs¹. The NETSO tends to lead the process and the output is an Information Note which sets out what the NETSO believes to be the most economic and efficient connection arrangement.

Whilst, superficially, this may appear to be a pragmatic approach to assessing the optimum connection arrangement, there are some specific consequences of the process which introduce uncertainty for offshore generators –

- The COIN process can be run a number of times and is not “locked down”.
Some COINs are on their eighth revision within a very short time period. As a

¹ The COIN process has, to date, only involved offshore generators rather than OFTOs, as all offshore generators have taken the “generator self-build” option for their transmission infrastructure.

result, offshore generators or OFTOs cannot have certainty about what is ultimately the optimum connection solution for their project.

- The COIN is an informal note which has no legal basis. While the NETSO may make a statement about the connection solution it believes to be economic and efficient, the final decision must be made by Ofgem, who may determine differently. As a result, the offshore generator or OFTO has no certainty that it will recover the cost of the connection on an ex post basis, even if it follows the NETSO's recommendation.
- If the COIN process recommends a solution which is contrary to the offshore generator's existing connection contract, the generator must pay for a modification to that contract, even though they may not have instigated the change to the connection solution. Furthermore, if the onshore TO has already commenced work to facilitate the offshore connection based on the existing connection contract, it is unclear who will bear the cost of the works required to facilitate the new modification.
- If the NETSO, through the COIN process, recommends a solution which imposes additional costs on the offshore generator or OFTO, in order to reduce costs to the onshore TOs, it is not clear how these costs will be recovered by the offshore generator or OFTO, and whether Ofgem will deem these costs economic and efficient. This is another area of uncertainty for the offshore generator.

We consider that there are lessons which can be learned from the COIN process to inform the area of general coordination between transmission entities. In particular, it is critical to establish accountability and provide certainty for system users, while maintaining transparency and consistency of process.

Integrated offers for offshore generators

The NETSO has commenced integrated offers for offshore generators where there are two or more generators within close proximity. The first generator applicant is made an offer which requires the applicant to oversize their transmission assets to allow for the future, nearby generator to connect.

As with the COIN process, this appears to be a pragmatic solution to the issue of multiple connections from closely located generators. However, as with the COIN process, there are a number of specific consequences which erode certainty for the generators.

- The first applicant is required to take the risk of the later applicants not materialising. The first applicant will have constructed an oversized transmission asset on the basis of their integrated offer but if the later applicants disappear, the asset will become stranded. As the cost recovery for these assets is on an ex post basis, it is not clear whether Ofgem will determine the additional investment to be economic and efficient if the later applicant fails to materialise. This introduces significant risk and uncertainty for offshore generators.
- The investment decision for offshore generators is clearly based upon their specific project. If they are required to fund additional transmission infrastructure for future applicants, while carrying the risk of stranding, this may introduce unwelcome pressure on their investment case and subsequently delay or discourage investment in the generation project.

The lessons to be learned from this process are around risk apportionment, the appropriateness of anticipatory investment and the maintenance of certainty and stability for investment.

Although both informal processes above could be used as examples of coordination, we consider that both are fundamentally flawed and introduce unnecessary uncertainty for both generators and TOs alike.

Potential for general coordination

We have set out our views on the issues included in the Open Letter and highlighted some further issues for consideration. Additionally, we have some views on how general coordination between transmission entities might be achieved.

Instructive or collaborative coordination

If the outcome of the Open Letter determines that further coordination between transmission entities is required, we consider that this coordination should be, in the first instance, both collaborative and light touch.

There exist a number of opportunities for coordination, specifically the Joint Planning Committee (JPC, as set out in the STC) and the Electricity Network Strategy Group (ENSG).

While the JPC has fallen into disuse in recent times, the structure and terms of reference remain useful. We consider that a route for greater coordination may be to widen the membership of the JPC to include OFTOs, interconnectors and generators so that a greater range of views are heard.

Alternatively, or additionally, the ENSG is a well established group including government, Ofgem and TOs. This group could also be expanded to include interconnectors and generators and given authority to assist coordination of the transmission network.

Whichever option is preferred, we consider that the first step should be to encourage coordination and collaboration by removing existing barriers and incentivising the behaviour of industry players in favour of coordination. Only if this method fails should instructive coordination (where one body has the power to direct specific coordinated investments in the transmission system) be considered.

Interactions with other work areas

We note Ofgem's acknowledgement of the interactions between the ITPR Project and a number of other areas of work currently in progress.

We consider that each of these other areas of work are critical to the outcome of the ITPR Project and vice versa. Additionally, we have highlighted the interaction between ITPR and Project Transmit and the necessity to include this interaction in the scope of the ITPR Project.

The scale of potential industry change, taking into account the other work areas highlighted as well as the ITPR Project, is vast. We consider that it should be Ofgem's first priority to provide regulatory certainty and maintain stability in the investment environment. There is a substantial risk that investment is undermined while such a range of activities take place and the outcome of these activities is, as yet, unknown.

We welcome Ofgem's review of the network planning and delivery arrangements for electricity transmission and we maintain that the most appropriate route for review is the Significant Code Review process, including the completion of a full Regulatory Impact Assessment at the earliest opportunity.

Impact on the current RIIO-T1 regulatory settlement

The RIIO-T1 price control period will commence on 1st April 2013 and last until 31st March 2021. It is critical that the outcome of the ITPR project does not alter the settlement agreed at RIIO-T1 and that any required changes are implemented after the end of this price control period.