



Making a positive difference
for energy consumers

Company Secretary
Scottish Hydro Electric Power Distribution plc
Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ
cc: Aileen Mcleod

Andrew Burgess
Direct Dial: 0207 901 7159
Email: Andrew.Burgess@ofgem.gov.uk

Date: 22 April 2014

Dear Company Secretary,

Ofgem's determination of Scottish Hydro Electric Power Distribution plc's (SHEPD) submission required under Charge Restriction Condition (CRC) 18A

1. Licence requirements and process to date

You presented a plan to manage the supply and demand of electricity on Shetland (the Integrated Plan) on 31 July 2013 as required under CRC18A of your licence. Alongside the Integrated Plan, you were also required to propose an Incentive Mechanism (IM) and a Relevant Adjustment (RA) to the Charge Restriction Conditions (CRC) in respect of the Shetland Integrated Plan Costs.

In your letter dated 4 September 2013, you explained why you had not submitted a relevant IM. As a consequence of not having done so, you had not complied with the requirements under the licence and had not served, at that time, a valid Notice as required under Part B of CRC 18A.

To recap, under CRC18A.16, when serving your Notice, you were to:

- a) set out the obligations or requirements to which the Notice relates;
- b) set out the basis on which you have calculated the RA;
- c) state the date from which you wish us to agree that the RA will have effect;
- d) include the Integrated Plan for Shetland; and
- e) include a relevant IM.

On 19 September 2013, we extended the deadline by which you had to propose the relevant IM (as specified in CRC18A.11) so that you could comply fully with the licence condition and serve a valid Notice as required by CRC18A.11.

When you submitted the "Shetland Integrated Plan Proposed Funding and Incentive Mechanisms" on 23 December 2013, you proposed an IM and a Cost Benefit Analysis (CBA) as an attachment to the Integrated Plan. At this point, we consider you had complied with the minimum that was required under the licence.

2. Our determination

By virtue of Part E of CRC18A, we may "confirm, reject or vary the relevant incentive mechanism proposed by the licensee and any RA if one is proposed by the licensee."

Based on our review and careful consideration of the documents, and having considered a report by independent consultants, DNV GL, we reject your proposed IM. Our reasons for this determination are in Section 3 of this letter.

We are keen to work with you to ensure that a relevant IM and appropriate RA are put in place. To that end, and in consultation with you, we have developed conditions that you will fulfil when undertaking the Integrated Plan. Please see section 4 of this letter. I would also like to thank your team for its constructive input in recent discussions.

3. Reasons for our determination

Our principal objective in exercising its functions under Part 1 of the Electricity Act 1989 is to protect the interest of existing and future consumers. We therefore need to ensure that the costs of the supply solution for Shetland are efficient. This is extremely important, as generation costs on Shetland are currently subsidised by SHEPD's customers. This is because the cost of power generation on Shetland is significantly higher than on the mainland due to its electricity system's isolated nature. To ensure we protect the interests of those customers by keeping the cost of the subsidy at the most efficient level over time, there must be a robust IM covering both the capital and operational costs associated with the Integrated Plan.

The relevant Incentive Mechanism

We have decided to reject your IM because we are not persuaded that it adequately incentivises the efficient capital and operational costs of the Integrated Plan. In your "Proposed Funding and Incentive Mechanisms" paper, you described an incentive for the delivery of the project. In our view, this mainly focuses on construction timings (section 5 of your paper) and we are not convinced that it adequately incentivises reducing costs, long-term costs such as continued operational costs (fuel), or short-term costs such as building the Integrated Plan solution (capital costs).

To ensure we protect consumers, there must be an IM to incentivise reducing capital and operational costs of the Integrated Plan. In section 4 of this letter, we describe the high-level principles which will ensure the most efficient outcome for consumers. We are keen to work with you to establish the details of the relevant IM as part of your delivery of the relevant conditions in this letter.

The Relevant Adjustment

The RA allows recovery of the incentivised costs associated with the Integrated Plan. It is therefore dependent on the costs of the Integrated Plan. It is also dependent on the IM, as it must include details necessary to effect the IM.

The RA must make adjustments to "the Charge Restriction Conditions as are necessary to enable the licensee to recover its [...] Shetland Integrated Plan Costs." (CRC18A.3). The current wording in Appendix 3 of CRC4 allows you only to recover efficient costs for generation from Lerwick Power Station (LPS) and current contracts with third parties.¹

¹ Sullom Voe Terminal - accurate to current arrangements

We will finalise the determination of the RA once an appropriate enduring solution for Shetland is identified and the relevant conditions have been fulfilled so that we have all the information needed to determine an appropriate RA. We are keen to continue working with you to develop an RA which allows you to recover the costs of implementing the Integrated Plan and which is appropriate in light of the IM.

We will also work with you to develop an adjustment to Appendix 3 of CRC4, to recover efficient costs incurred in the interim associated with continuing to meet demand requirements on Shetland, including contingency arrangements, from the start of RIIO-ED1. This will include the efficient costs to be incurred in recruiting an Independent Auditor. As specified in DPCR5 Final Proposals, once you submit these to us, we will also conduct an ex post efficiency review of your accrued costs in the development of the Integrated Plan. This will include your efficient costs associated with securing bids from two companies.²

Our considerations of the Integrated Plan Costs

In determining the IM, we have reviewed the Integrated Plan Costs and CBA you have submitted. A significant proportion of the solution's costs will be recouped through a cross-subsidy. We must therefore be satisfied that these costs provide the best value for consumers and do not burden those currently subsidising the costs on Shetland more than is necessary or appropriate. We are concerned that your proposed costs were higher than expected and as a result the impact on customers' bills would be higher than appropriate.

In particular, we are not persuaded that:

1. you have sufficiently tested the market for an efficient and economical solution. We consider that your analysis of the CBA options was not as extensive as would be expected. We also consider that further analysis of options not considered in the CBA would be appropriate. We are not satisfied that:
 - a. alternatives to the proposal to build a new power station have been adequately considered;
 - b. you have provided adequate cost assessments of the alternatives in the CBA; and
 - c. you have explained sufficiently why you have discarded a number of options.
2. the costs put forward are the most efficient and competitive, as you have not provided sufficient supporting evidence to demonstrate this. For example, we are not persuaded that the costs are justified by the suggestion that your proposed solution is a "first of a kind" power station.

We are keen to ensure that the solution for supply on Shetland is cost-efficient, innovative and flexible. We consider that the lowest cost and most efficient solution will be that determined by a competitive market process. Therefore, the conditions to our determination include competitive elements to decide the solution for Shetland (see section 4). We want to work with you to ensure that the relevant conditions are fulfilled and that they lead to the best outcome for consumers.

4. Relevant conditions attached to our determination

² MAN and Wärtsilä

In consultation with you, to determine the IM and RA, we have determined, and you have agreed to fulfil, the following relevant conditions under CRC18A.18 when undertaking the Integrated Plan for Shetland. We are keen to continue working with you to ensure the development and delivery of the best value and most efficient solution for Shetland.

1. An independent auditor, experienced in competitive procurement, including of power generation, will be appointed to oversee, agree and report to us on the competitive process. The auditor's role will be four-fold:
 - i. They will work with you to devise the background documents to the tender, including the demand forecast, information on existing generation, and future supply requirements.
 - ii. They will ensure that the best practice competitive process is open, fair and equitable.
 - iii. They will be involved in drafting the selection criteria for assessment and selection of bids during the competitive process.
 - iv. They will oversee the assessment of the bids during the competitive process.

For selecting the auditor and working with them:

- a. We will work with you to jointly develop the process and timeline for selecting the auditor.
 - b. We will jointly develop the terms of reference for the auditor.
 - c. We will work collaboratively during the auditor selection process. You will provide a nomination to us for our approval, which approval will not be unreasonably withheld.
 - d. The auditor will update us regularly, as we may require, and these updates may be published, subject to justified confidentiality restrictions.
 - e. The efficient costs for the independent auditor will be recovered through your licence during RIIO-ED1. We will work with you to develop an adjustment to Appendix 3 of CRC4 to allow for the recovery of these efficient costs.
 - f. None of the provisions above preclude both parties from agreeing additional activities on the part of the independent auditor.
2. An open and public consultation process will precede the competitive process to ensure that all potential solutions and stakeholder considerations have been explored:
 - a. You will consult on the options put forward in your CBA and Integrated Plan, requesting views on the proposed and any other potential options.
 - b. You will invite views on risk sharing mechanisms and an appropriate incentive mechanism.
 - c. Responses to the public consultation will be used to develop the scope of the competitive process documents and selection criteria.
 3. You will run a competitive process to identify the most efficient solution for Shetland.
 - a. The tender document will specify (but will not be limited to) the following:
 - i. security of supply standards - together with the independent auditor, you will verify and set out the demand forecasts and power supply requirements for the competitive process documents;
 - ii. the life of the solution proposed and its required flexibility and modularity;
 - iii. environmental compliance standards;
 - iv. operational specifications;

- v. appropriate commercial mechanisms - including risk sharing mechanisms and incentive mechanisms to ensure least cost over the life of the project.
 - b. The technical and commercial requirements of the tender must ensure the widest possible field of bidders, without compromising security of supply.
 - c. Participants, or a consortium of participants, may propose multiple solutions in their bid or multiple bids with different scope.
 - d. The competition will be open to smart, flexible, innovative and hybrid solutions which are compatible with the evolving energy needs on Shetland (eg increasing wind capacity, potential link to mainland GB, District Heating systems etc).
 - e. The competition will also be open to proposals involving the continued use of existing assets or infrastructure on Shetland.
 - f. Solutions must allow for the integration of, and should be informed by, the Shetland Trial (Northern Isles New Energy Solution (NINES)). The bidders should take the learning, progress and if applicable the outcome of the Shetland Trial into account when developing their bids such that their proposed solutions are informed, and integrated with, the Shetland Trial. In particular, SHEPD will produce a report on the outcomes and progress of the Shetland Trial, and provide this to bidders at an appropriate stage in the tender process prior to the submission of bids.
 - g. The efficient cost of the competitive process will be recovered through an adjustment to Appendix 3 of CRC4. We will assess these costs and work with you to develop an adjustment to Appendix 3 of CRC4 to allow efficient costs to be recovered during RIIO-ED1.
4. Cost efficiency should be ensured and encouraged for the short, medium and long term through an IM, which will be informed by the results of the competitive process.
- a. The IM should incentivise efficiency in both upfront capital and on-going operational costs.
 - b. We would expect the IM to reduce costs over time.
 - i. The IM should incentivise a reduction in the capital costs, both upfront and throughout the life of the solution. This will include upfront capital costs and on-going maintenance costs, as well as future upgrades and replacements.
 - ii. On operational costs, the IM should aim to reduce these costs (including any fuel burn) over time and for the resulting savings to be shared between you and consumers (and the provider of the solution, if appropriate).
 - c. We will agree the specific details with respect to the IM that will be included in the tender in consultation with you. The RA for the costs which will be incentivised by the IM will be finalised following the outcome of the competitive process.
5. After this two-stage approach, which includes a public consultation and an open competitive process, you will submit for our approval the RA for the incentivised costs of the Integrated Plan. This will also include changes to the licence which will effect the IM. We currently expect that you will submit this to us within approximately 12 months of this decision. However, we will continue to work with you to firm up the relevant timetable.

We will then determine the RA within a reasonable time to allow us to go through the standard mandatory statutory consultation process. In determining the RA, we will

finalise the details of the IM in consultation with you and taking into account your proposal. We will not unduly delay the process.

6. Energy supply on Shetland has been and is likely to continue to be more expensive than in the rest of GB. Pursuant to Appendix 3 of CRC4 and CRC3 of SHEPD's Special Licence Conditions, SHEPD is allowed to recover the price differential between the cost of generation on Shetland and the market price on the mainland. We anticipate that an arrangement of this nature will continue. In order to facilitate extant Government policy regarding the pass through of any relevant and efficient costs arising from the most efficient solution for Shetland, SHEPD is to comply with any lawful direction made by the Secretary of State relating to the cost recovery arrangements for the energy supply on Shetland. Until such a direction from the Secretary of State is effected, you may wish to include appropriate conditions in the connection offers you make to safeguard you from the risk that certain consumers may not receive the benefit of the current cost recovery arrangements.

5. Shetland Contingency Plan

On 23 December 2013, you shared with us an overview paper about the use of supplementary mobile generation, and active network management, to address potential deficits in generation adequacy in the event of a major generation outage. We trust that you are confident that these arrangements are sufficient to ensure continuation of supply on the island in the event of contingency and that these have been appropriately quality controlled.

We will work with you to adjust Appendix 3 of CRC4 to provide for the recovery of efficient costs associated with any necessary activation of the contingency arrangements. We expect these arrangements to reflect the need to keep costs as low as reasonably practicable. Evidence of this should be submitted to us for efficiency review ahead of cost pass-through being allowed for under the ED1 licence.

6. Next steps

In accordance with CRC18A.19 we have consulted with you in determining the IM, RA and relevant conditions and had regard to your comments in our final determination.

We will continue to engage with you to agree an interim adjustment to Appendix 3 of CRC4. This is in relation to continuing the pass-through arrangements for the first three years of RII0-ED1 or until the IM and RA take effect. We are keen to agree the efficient costs of these transitional arrangements, which will also take into account any efficient contingency plan costs for Shetland and the efficient costs of the independent auditor. We will also consider and discuss any reporting requirements, including the evidence required, to pass through these efficient costs. Please note that we would understandably be concerned about, and would require proper justification for, any increase in the costs of the transitional arrangements compensated through Appendix 3 of CRC4. This also relates to the costs associated with an extension of your Power Purchase Agreement with Sullom Voe Terminal.

This document constitutes a notice of reasons for our decision to determine relevant conditions arising from the operation of CRC18A.18 of your licence under section 49A of the Electricity Act 1989.

If you would like to discuss any of the issues raised in this letter, please contact Dora Guzeleva (Dora.Guzeleva@ofgem.gov.uk or 020 7901 1851) or Giulia Buttini (Giulia.Buttini@ofgem.gov.uk).

Yours faithfully,

A handwritten signature in blue ink that reads "Andy Burgess". The signature is written in a cursive, flowing style.

Andy Burgess

Associate Partner, Transmission and Distribution Policy

Signed on behalf of the Authority and authorised for that purpose.