

Rt Hon Alex Salmond MSP
First Minister of Scotland

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David Gray
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Ofgem
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In 2014 Scotland Welcomes the World



— 22 May 2014

Dear David,

When we spoke on 14 March you highlighted a further delay - to April 2016 – in implementation of the changes Ofgem is now minded to make to the current transmission charging regime in Project TransmiT. The changes will reduce the scale of the variance in charging faced by most Scottish generators, support the transition to a low carbon economy by encouraging renewable energy generation in the areas of highest resource, protect the interests of consumers and ensure Scotland plays its crucial role in delivering security of GB supply and meeting environmental targets.

As you know, I have consistently stated that Project TransmiT must deliver an enduring transmission charging regime capable of meeting the aims we all share of a sustainable, secure and affordable low carbon energy future. I welcome that the changes you are minded to make will better help deliver that.

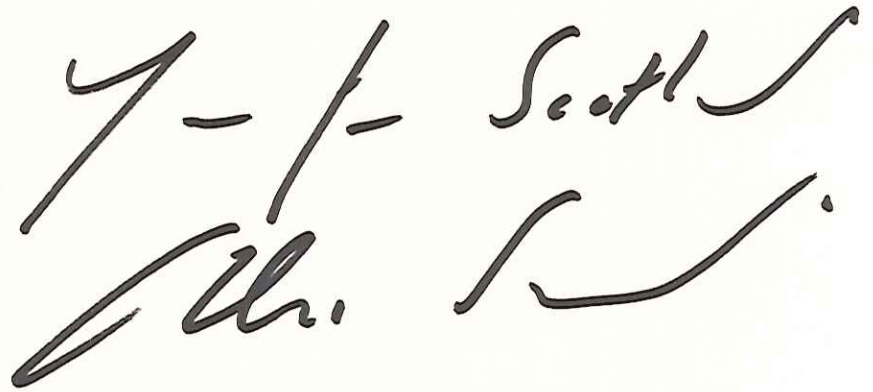
You also advised Ofgem would undertake a further period of consultation, believing this was necessary in light of the responses to the main consultation on the changes and, in particular, late arguments presented in the alternative impact assessment of your proposed changes from one party. I attach a detailed Scottish Government response to that further consultation, issued by Ofgem on 25 April.

On 21 March, I chaired an exceptional meeting of the Scottish Energy Advisory Board's Grid and Regulation group to assess the impact of further delay in the crucial decision-making on your changes. There was broad consensus that the review of transmission charging over the last three and a half years has clearly demonstrated the case for change. There was also consensus on the pressing need for clarity on the way forward. In addition, we have identified that that the two year delay in implementing change to April 2016, will cost Scottish generators around £90 million – illustrating the adverse effect both of the current charging framework and the impact of prolonging it .

The Project TransmiT process which has taken us to this point has looked in depth at the technical issues; it has been conducted in a robust and transparent manner and every reasonable opportunity has now been offered for stakeholders to interpret and challenge the evidence.

That being the case, I strongly urge Ofgem to publish a final decision as soon as possible and confirm implementation of the minded-to position by no later than April 2016.

I am copying this letter to members of the Scottish Energy Advisory Board.

A handwritten signature in black ink, appearing to read "Y-f- Scott" on the top line and "Alex Salmond" on the bottom line. The signature is fluid and cursive.

ALEX SALMOND

Project Transmit Consultation

The Scottish Government's response to the further consultation on proposals to change the electricity transmission charging methodology

Aims of Project Transmit

Project Transmit was designed to support the transition to a low carbon electricity generating mix, to deliver secure and affordable electricity supplies, and address several defects in the current transmission charging methodology – for example, by reflecting more accurately the actual drivers of the costs of reinforcing the transmission network.

In some parts of the system, transmission reinforcement is driven by the need to secure imports of power, the critical condition generally being peak demand. In other parts of the system, transmission reinforcement is driven by exports of power with a trade-off being made between the cost of transmission infrastructure and cost of constraints. To be accurate, the latter should be assessed for conditions that can be reasonably foreseen to arise in the course of a typical year of operation.

The Scottish Government considers the modification that Ofgem is 'minded-to' implement – known as WACM2 – supports the objectives of Project Transmit and improves cost reflectivity, and hence provides more accurate signals to, in particular, generation investors of the transmission cost of siting decisions. In turn, more accurate signalling of these costs would be expected to produce more efficient generation investment decisions.

Furthermore, we believe that WACM2 reduces discrimination between market participants and promotes competition; we also share the Ofgem view that WACM2 better facilitates the Authority's principal objective of protecting the interests of existing and future electricity consumers.

Scottish impacts

In March, following the announcement of Ofgem's intention to further defer a decision on implementation, the First Minister convened discussions with industry and academic experts to discuss the implications for Scotland. From this, broad consensus has emerged that the case for change had been proved and on the urgent need for clarity on the date of implementation. Progress for low carbon generation, security of supply and realisation of the socio-economic benefits (in many cases, for vulnerable communities) are at risk while this uncertainty remains.

Overall, the impact of two years' delay in implementation of a new system of transmission charges equates to around £90 million of extra transmission costs for Scottish generation. This situation is not acceptable following such a lengthy and robust process, and we have argued that Ofgem should take every step possible to mitigate it by implementing the proposed changes by April 2015. Failing that Ofgem must implement the proposed changes by April 2016 at the very latest.

Commentary on the further analysis

In August 2013, Ofgem concluded that WACM2 was the most cost-reflective option arising from Project Transmit and one that would drive more economically efficient decisions by market participants and, ultimately, yield value for electricity consumers.

The further analysis produced by Baringa, which was published alongside the current consultation, broadly supports the conclusions of the original modelling carried out National Grid Electricity Transmission (NGET) – and reinforces the central conclusion that a more cost reflective approach is in the long-term interest of consumers.

In commenting on the updated analysis, we would highlight the following points:

- Cost reflectivity – A key reason to support implementation of WACM2 is the improvement in cost reflectivity that comes from differentiating between investment driven by peak security and investment driven by managing constraint cost. Better reflecting this distinction helps substantially to reduce discrimination against generators based in Scotland and thereby enhances competition by levelling the playing field.
- Power sector costs – The Baringa analysis predicts more renewable deployment will take place at higher yielding sites under WACM2 – particularly in the North of Scotland – and thus power sector costs fall. Increased cost reflectivity and the response of generators to move northwards are shown to more than offset higher transmission costs.
- Renewables targets – The prospects of meeting the Scottish Government’s long term renewables targets at lower cost is improved by WACM2, as producer costs and CfD strike prices are lower under WACM2 than under the status quo. For the GB market as whole, because of the shift in deployment to higher yielding sites, a lower level of development would be needed to achieve a given renewables target.
- Consumer impacts – We welcome Ofgem’s conclusion that WACM2 will result in long-term consumer benefits and note that Baringa’s cost benefit analysis of implementing WACM2 produces a range of impacts on average consumer bills over different periods of time. Whilst some of these results give rise to concern in isolation, we note the many caveats attached, namely: that the modelling does not present a full picture of the impact on consumers or capture certain dynamic effects such as the entry of new generators into the market, who would be expected to enhance competition so that lower power sector costs pass through to consumers.

Consultation process

It is absolutely correct that proposals for change in electricity transmission charging methodology are tested and that Ofgem consults fully, seeking views on whether, in the end, proposals are in consumers’ long-term interests. Those interests should also be cognisant of government policy, not least in respect of reduction of carbon emissions and the most cost-effective way of doing so while still attracting sufficient investment.

The process to consider changes to the transmission charging methodology has been a long one that has given stakeholders every opportunity to be informed about the proposals and to comment. For the process to have taken so long and to have recently been subject to further delays when the majority of the industry is apparently in agreement that the proposals represent an improvement and are in consumers’ best interests, does little to enhance the reputation of an industry that is currently ill-regarded by the public. Moreover, it is widely

agreed that investment in new generation capacity is required. This investment requires firm decisions to be made by investors who in turn require as much certainty as possible about the investment environment, including the transmission charging methodology.

Implementation

Given the points above, including the lengthy period of analysis and consultation, the Scottish Government would strongly urge Ofgem to implement the minded-to position without any further delay. The most recent delay in the decision-making process has compounded the uncertainty faced by Scottish generators who already have to deal with the UK Government's slow and piecemeal introduction of Electricity Market Reform. To delay implementation beyond April 2016 would represent a serious failure of the process and indeed there is strong justification for implementation even sooner than that.

Scottish Government
May 2014