

Inveralmond House  
200 Dunkeld Road  
Perth PH1 3AQ  
email: aileen.mcleod@sse.com

Kersti Berge  
Partner, Electricity Transmission  
Ofgem  
9 Millbank  
London  
SW1P 3GE

Date: 18 November 2014

Dear Kersti

### **Consultation on our assessment of the Caithness Moray transmission project**

Scottish Hydro Electric (SHE) Transmission welcomes the opportunity to respond to this consultation on the assessment of the efficient cost of delivering the Caithness Moray transmission project in the north east of Scotland. SHE Transmission is disappointed with the proposed allowance set out in the consultation as we believe there is strong evidence to support the forecast cost set out in our December 2013 (updated in March 2014) Strategic Wider Works costs submissions. We are committed to continuing to work with Ofgem in assessing all of the evidence during the consultation period.

#### *Proposed allowance*

The consultation proposes an allowed expenditure of £1,062.3 million (2013/14 prices) for the efficient costs of delivery. We note that this is an initial view and the consultation states that further information is to be taken into consideration in the final decision including:

- § Information submitted by SHE Transmission in September/October 2014.
- § The updated version of the project risk register (dated September 2014).
- § Items in DNV GL's assessment for further consideration by Ofgem, e.g. site specific expenditure.
- § Options for managing cost uncertainty (see below).

The Caithness Moray investment is a complex project, with multiple work elements – including offshore HVDC works, onshore convertors and substations, and new and replacement overhead lines – and construction over a large, remote geographic area. In addition, there are multiple contractors engaged in the delivery of the works over a prolonged period. As a consequence, this has been a challenging cost

assessment and, as has been the case throughout the process, SHE Transmission is committed to providing whatever assistance is required by Ofgem and its consultants in undertaking an effective assessment.

SHE Transmission has concerns around the conclusions reached, at this point, in a number of areas. In particular, we highlight:

- § Site specific costs have not been included within the benchmarks for AC substations. Inclusion of these costs accounts for over 80% of the variance between our forecast and the benchmark. In addition, we are concerned that benchmarking adjustments have not been applied symmetrically; that is, adjustments have only been made where costs are more than 10% above the benchmark and not where they are 10% below.
- § The assessment of the allowance for risk is based on a statistically invalid sample of risk events that has been mechanistically extrapolated across the remainder of the risk register. No subsequent probabilistic modelling of the risk outcomes has been undertaken. This raised significant doubts over the validity of the outcome, particularly when the proposed risk allowance (as a per cent of total project costs) is an outlier for comparable global large infrastructure projects.
- § Contract negotiated items appear to have been treated as uncertain costs, or risk items, when these expenditure items are of known scope and market-based cost.
- § The proposed project management resource levels assume the main contractor takes more responsibility for the engineering, delivery and commissioning than is set out in the associated contracts and would be permitted under industry codes and policies. There is also an assumption that resources can be optimally 'switched on and off' to exactly align with activity schedules; hence, not accounting for pre- and post- activity works.

Taken together, these issues are material and place the project at undue risk. We have provided all the necessary information to Ofgem to fully assess these concerns, and would expect these to be addressed in the final decision.

#### *Treatment of risk*

The consultation document comments on the problems with managing cost uncertainty in large capital projects and the existing regulatory mechanisms for addressing this. SHE Transmission has significant concerns around the effectiveness of these existing mechanisms for the Caithness Moray project, particularly given the issues with the assessment of the forecast risk allowance described above.

Caithness Moray is a high value transmission investment, equivalent to 95% of SHE Transmission's prevailing RAV. The impact of Ofgem's consultants' assessment of uncertain costs is to transfer significant uncontrollable costs onto SHE Transmission without an agreed and 'bankable' cost recovery mechanism. The regulatory funding arrangements have a 'gap' that introduces unnecessary cash flow risk and allows for

only partial recovery of efficiently incurred costs. For a project of the scale of Caithness Moray, this represents undue regulatory risk.

In seeking to close this gap for the Caithness Moray project, SHE Transmission has examined a number of regulatory options. Essential to an acceptable outcome in this regard is: (i) to close the timing gap between efficiently incurred expenditure and cost recovery; and (ii) a 'bankable' opportunity for full recovery of efficiently incurred costs over-and-above the ex-ante allowance. We welcome further discussions with Ofgem on this issue.

#### *Expenditure profile*

Annex 1 of the consultation sets out an annual expenditure profile for the Caithness Moray. This appears to apply the proposed reduction to SHE Transmission's annual expenditure forecast on a pro-rata basis across each individual year of spend. This approach does not align the cost reductions with when those costs were forecast to be incurred – in practice, this front loads the reductions and exacerbates SHE Transmission's cash flow risk. We strongly urge Ofgem, if it determines to reduce SHE Transmission's forecast expenditure, to align the reductions with the forecast timing of expenditure.

I hope this information is helpful to you in reaching a conclusion on the Caithness Moray project. If we can provide any further assistance then please do not hesitate to get in touch.

Yours sincerely

**Aileen McLeod**  
**Head of Regulation, Networks**