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Transmission licensees,
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groups and other interested
parties

Direct Dial: 020 7901 7223
Email: kersti.berge@ofgem.gov.uk
Date: 23 January 2015

Dear colleague,

Consultation on Scottish Power Transmission Ltd's opening asset value for project 'Sloy'

The Sloy project is an electricity transmission investment to relieve constraints on Scottish Hydro Electric (SHE) Transmission's transmission network by using spare capacity on the Scottish Power (SP) Transmission network. It has been funded under the conditions of the Transmission Investment for Renewable Generation (TIRG) mechanism. The project has been delivered jointly between the two Transmission Owners (TOs). The outputs associated with SP Transmission's work on the project were delivered in 2009/10.

The TIRG conditions require us to determine the post-construction Opening Asset Value (OAV). The finalised value will determine the revenue that SP Transmission receives for the 5 years following construction. This consultation is on our view that this valuation should remain at £19.366 million[1], which is the level set by our determination to provide additional funding for the project on 25 November 2010[2].

We have reached this provisional view because we consider that the total expenditure for Sloy has been efficiently incurred by SP Transmission. We also consider that the five-year post-construction incentive period should begin from 2009-10, which is when SP Transmission delivered the relevant outputs.

We would like to hear your responses to the questions below by 20 February 2015.

1. Do you agree that no change should be made to the post-construction revenues as a result of the commissioning delay?
2. Do you agree with our assessment that the opening asset value for the Sloy project should be £19.366 million?
3. Is there any other information you think we should take into account when making our decision in relation to the opening asset value for project Sloy?

In addition to seeking your views on the appropriate opening asset value and post construction revenue allowance for this project, we would like to draw your attention to the fact that we have recently finalised a modification to Special Condition 3J. Paragraph 3J.7 of that condition sets out the calculation of TIRG post-construction revenues. We have identified a typographical error in this formula and an incorrectly referenced term. In

[1] All prices stated in the consultation document are in 2009/2010 prices.

[2] https://www.ofgem.gov.uk/publications-and-updates/transmission-investment-renewable-generation-tirg-determination-asset-value-adjusting-event-transmission-investment-project-sloy-scottish-power

October we consulted on correcting these errors[3], and published our decision on 3 December 2014[4]. The changes will take effect from 27 January 2015.

Background to TIRG

The TIRG mechanism was established in 2004 to fund transmission projects to connect renewable generation outside the price control process. The intention was to minimise investment delays. TIRG gives the three electricity TOs expenditure allowances for specific transmission reinforcement projects. Since the design and associated costs of these projects are uncertain, a degree of flexibility was built into the process to allow amending the revenue allowances.

The various TIRG projects, including Sloy, can be broken down into four distinct phases and defined as follows:

Pre-construction	Construction	Post-Construction[5] period	Regulated Asset Value period[6]
Period prior to construction	Period of construction. The length of the construction period is set out in the Licence with an annual revenue allowance set for each year.	Period of 5 years which begins one year after output is delivered	15 year period during which any savings are shared with consumers

During the five-year post-construction period, which starts the year after construction ends, the TOs can keep cost savings if they deliver the project for below forecasted cost. This gives TOs an incentive to deliver projects efficiently. At the end of this period, any cost savings are passed on to consumers.

Background to project Sloy

The Sloy project aims to use spare capacity on an existing SP Transmission line to increase the capacity of SHE Transmission's southwest boundary. This has been achieved by building the Inverarnan substation, which comprises two supergrid transformers (SGTs) interconnecting SP Transmission's 275kV and SHE Transmission's 132kV systems. SP Transmission and SHE Transmission were responsible for the project construction works in their respective transmission areas. In certain cases, where contracted work related to work in both SP Transmission's and SHE Transmission's areas, costs were allocated accordingly.

Although SP Transmission completed its construction works for Sloy in 2009-10, the substation did not start operating until 2011-12. This was because contractors hired by SHE Transmission damaged the SGTs, which formed part of SHE Transmission's works. The manufacturer repaired the damage at no extra cost to SHE Transmission. This allowed the transmission operator to commission its works in 2011-12. After this, the substation started operating. There were no constraint costs resulting from the delay.

[3] https://www.ofgem.gov.uk/publications-and-updates/notice-proposed-licence-modifications-special-licence-condition-3j-electricity-transmission-licence

[4] https://www.ofgem.gov.uk/publications-and-updates/decision-proposed-licence-modifications-special-licence-condition-3j-electricity-transmission-licence

[5] In the licence this term is referred to as the 'incentive period' and also as 'the TIRG relevant years'

[6] https://www.ofgem.gov.uk/ofgem-publications/48279/glossary.pdf

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In January 2012[7], we made a determination on SHE Transmission's opening asset value. We decided that SHE Transmission should only be allowed to collect post-construction revenues after the commissioning of the project (i.e. from 2012-13). This required a revenue adjustment to recover the post-construction revenues collected in 2010-11 and 2011-12. This effectively delayed the post-construction revenue stream to SHE Transmission by two years (in net present value terms) to 2012-13. There were two main reasons for our decision:

1) The project did not operate during the period of delay, thus delivering no output to network users, which would make it eligible for post-construction funding.
2) We consider that it is up to the licensee to manage the risks in contracting, procurement and any potential lost revenues associated with them. The licensee – rather than the consumer – is best-placed to manage these risks. We also consider that the licensees should be responsible for all of their actions, including where they engage third parties.

Setting the Opening Asset Value

When determining the OAV, we are required to consider the following criteria:

- Whether an adjustment has been made to the average asset value and depreciation value for the transmission investment project during the construction period.
- Whether the final aggregate transmission investment expenditure set out in the post-construction expenditure report has been efficiently incurred.
- Whether the licensee has complied with the output measures specified in Schedule C of the TIRG condition for the transmission investment project.
- Any other information the Authority considers to be relevant to the determination.

These points are discussed below in relation to our initial determination on SP Transmission's OAV for project Sloy.

Asset Value Adjusting Event

In 2004, when the revenue allowances for TIRG were approved, the cost forecast for SP Transmission's part of the work was £15.4 million. However, in 2008 SP Transmission notified the Authority of an AVAE[8] brought on by higher envisaged construction costs. SP Transmission contended that this increase in costs was driven by three factors:

1. **Site-specific civil works**. The site ultimately chosen for development required the construction of an 800-metre access road. This was longer than initially anticipated. Further, there was a need for extensive civil excavation and building three bridges to cross a watercourse. Moreover, the soil and site investigation report identified a large proportion of rocks that would need to be removed to allow a level, well-drained substation platform. SHE Transmission was responsible for the delivery of the access road, with SP Transmission charged proportionately for the work.

2. **Site-specific overhead line works**. So not to disconnect the Cruachan power station and incur constraint costs that consumers would ultimately bear, SP Transmission constructed a temporary tower to maintain the connection.

[7] https://www.ofgem.gov.uk/publications-and-updates/transmission-investment-renewable-generation-tirg-determination-asset-value-adjusting-event-transmission-investment-project-sloy-scottish-power

[8] Asset Value Adjusting Events apply in the construction period and are resultant from either additional construction work or a change in scope to the same.

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3. **Distribution circuit crossings**. SP Transmission identified twenty crossing points of the transmission and distribution systems that needed undergrounding. This was to enable the overhead transmission lines to be constructed safely.

In November 2010[9], we approved the AVAE which increased the forecast cost to £19.6 million.

Efficiency of costs incurred

After completing its part of the works in 2009-10, SP Transmission reported that it had incurred a final aggregate expenditure of £15.2 million. As this was lower than the £19.6 million expenditure allowance, we queried how SP Transmission was able to achieve such savings. In its response, the company highlighted that:

1. Environmental planning conditions were relaxed to allow building a conduit to safeguard an ancient settlement. This resulted in a shorter access road and avoided the costs of constructing a bridge.
2. It avoided importing stone chips by using locally-excavated stone instead, crushing it on site and reusing it for constructing the substation platform.
3. It had the opportunity to hire a temporary by-pass tower to support the existing overhead line, which avoided the cost of purchasing a temporary tower.
4. Positive engagement from landowners led to fewer and shorter overhead line access roads and avoided completely the requirement for a bridge at Glen Gyle. This also resulted in less need for helicopters to bring in materials for the overhead line part of the project.
5. The tendering process produced further savings against the overall allowance.

In reaching our initial view of the opening asset value, we have taken into consideration that SP Transmission incurred a final aggregate expenditure of £15.2 million for the Sloy project against an expenditure allowance of £19.6 million. Through successfully engaging stakeholders, utilising alternative means of delivering the final output and designing a more robust tendering process to improve efficiency, SP Transmission was able to achieve the desired outcome at a lower cost. TIRG incentivises companies to come up with solutions to deliver projects at below forecasted cost for the benefit of consumers. We consider that the difference between the final expenditure and allowance is a cost-saving which should not change the opening asset value of £19.366 million.

We also challenged SP Transmission on why the realised cost savings had not been factored in as reductions to its AVAE submission in 2008. SP Transmission subsequently provided evidence to demonstrate that the extent of the cost savings ultimately achieved had not been revealed at the point at which they requested the AVAE. We are confident that the potential solutions offered by SP Transmission at the time of their AVAE submission seemed the most effective for the complications faced; particularly as they were not the principal contractor for certain elements of the work where cost savings were ultimately delivered. We believe that the company should be allowed to keep these cost savings, as per the underlying principles which underpin the TIRG mechanism.

Further, SP Transmission provided a Construction Completion Certificate as part of SKM's post-construction technical report. This confirms that SP Transmission completed its construction activities efficiently.

Compliance with project-specific outputs

In January 2013, SP Transmission submitted to us the relevant post construction reports for the Sloy project. SP Transmission said it considered that the project commissioning year (year t=n, as set out in the TIRG condition) was 2009-10. This was supported by the

[9] https://www.ofgem.gov.uk/ofgem-publications/52623/tirg-sloy-sp-november-25-2.pdf

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Construction Completion Certificate attached to the independent technical report, which confirmed that SP Transmission completed all construction activities necessary to fulfil its obligations during 2009-10.

SP Transmission believes it fulfilled its TIRG licence condition in 2009-10, even though the full benefit of the increased outputs was not realised until 2011-12 when the substation become operational. The company does not believe it should be penalised for the delay in commissioning which was caused by contractors of SHE Transmission. It contends that it had no influence or direct contact with these contractors when they were completing their works. Taking this and the fact that there were no constraint costs to consumers from the delay, we believe SP Transmission's incentive period post-construction revenue should start from 2010-11 and run for five years as per the licence.

We consider that licensees should not be penalised if they have no control over a delay. In reaching our initial determination for SP Transmission, we are of the opinion that SP Transmission had no control over the actions of SHE Transmission's sub-contractors who caused the delay. Therefore, we do not believe that SP Transmission should be prevented from claiming the five-year post-construction revenue allowance from 2010-11.

Next steps

We welcome responses to the issues we have raised in this letter by 20 February 2015. Unless clearly marked as confidential, we will publish responses on our website. Should you wish to discuss the issues raised in this document, or provide responses to the questions we have raised, please contact Saad Mustafa at saad.mustafa@ofgem.gov.uk or on 020 7901 7114.

Yours sincerely,

Kersti Berge
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