

Transmission licensees,  
generators, suppliers, consumer  
groups and other interested  
parties

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Dear colleague,

### **Decision 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 network by using spare capacity on the Scottish Power Transmission network (SPT). It has been funded under the conditions of the Transmission Investment for Renewable Generation (TIRG) mechanism<sup>1</sup>. The project has been delivered jointly between the two Transmission Owners (TOs). The outputs associated with SPT's work on the project were delivered in 2009/10.

The TIRG conditions require us to determine the post-construction Opening Asset Value (OAV). Following our consultation in January, this determination confirms our decision that this valuation should remain at £19.366 million<sup>2</sup>, which is the level set by our determination to provide additional funding for the project on 25 November 2010<sup>3</sup>. The finalised value confirms the revenue that SPT receives for the 5 years following construction.

### **The January consultation**

Our consultation in January explained that we had reached this view because we considered that the total expenditure for Sloy has been efficiently incurred by SPT. It also explained that we considered that the five-year post-construction incentive period should begin from 2010/11, which is when SPT delivered the relevant outputs.

### **Responses to our consultation**

We received two responses to our consultation.

SPT agreed with our initial view of the OAV for the project. SPT also pointed out that the consultation incorrectly referenced the post-construction revenues as having been set by our determination to provide additional funding for the project on 25 November 2010. Its confidential response explains that their licence was never updated to reflect the additional funding they received.

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<sup>1</sup> Background on the TIRG mechanism can be found in Appendix 1 of this letter

<sup>2</sup> All prices stated in the consultation document are in 2009/2010 prices.

<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/transmission-investment-renewable-generation-tirg-determination-asset-value-adjusting-event-transmission-investment-project-sloy-scottish-power>

SHE Transmission drew parallels between the Sloy project and the Beauldy-Denny project, another project funded through the TIRG mechanism where the two companies have been jointly responsible for the overall project's delivery. It also raised concerns over the timing of our consultation on the OAV, as it comes in the final year of the incentive period. We will continue to engage with SHE Transmission to ensure that everything is in place to allow us to reach a decision on its Beauldy-Denny project in as timely a manner as possible once the project has been completed.

### **Our consideration to consultation responses**

Further examination of the revenues recovered by SPT since 2010/11 confirms that its revenue allowances were not updated to reflect the additional funding it received. This does not impact on the outcome of this decision, but means that an adjustment should be made to SPT's revenue to account for it having received less revenue than it should have done during the post-construction period. We will do this by requiring SPT to restate its historical allowed revenues for the project. There is a correction factor that operates within SPT's licence, which will then automatically adjust SPT's 2016/17 allowed revenue to account for the additional revenue that should have already been recovered. Further detail of how this correction factor works can be found in Appendix 2 to this letter.

### **Background to project Sloy**

The Sloy project aimed to use spare capacity on an existing SPT 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 SPT's 275kV and SHE Transmission's 132kV systems. SPT and SHE Transmission were responsible for the project construction works in their respective transmission areas. In certain cases, where specific contracted work related to work in areas, costs were allocated accordingly.

Although SPT 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.

In January 2012<sup>4</sup>, 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).

Further background on the project can be found in the January consultation.

### **Determining the Opening Asset Value**

The January consultation set out that SPT's underspend against the additional funding provided in 2010 represented efficient delivery. It also explained that the full outputs of the project were delivered on time by SPT. Appendix 3 sets out our findings against the criteria by which we determine a TIRG project's OAV.

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<sup>4</sup> <https://www.ofgem.gov.uk/publications-and-updates/transmission-investment-renewable-generation-tirg-determination-asset-value-adjusting-event-transmission-investment-project-sloy-scottish-power>

## Next steps

SPT must restate historical allowed revenue to allow the correction factor to flow through the adjustment to revenue into its 2016/17 allowed revenue.

Should you wish to discuss the issues raised in this document, please contact Thomas Johns at [thomas.johns@ofgem.gov.uk](mailto:thomas.johns@ofgem.gov.uk) or on 020 7901 7046.

Yours sincerely,



Kersti Berge  
Partner, Electricity Transmission

## Appendix 1 - 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:

<b>Pre-construction</b>	<b>Construction</b>	<b>Post-Construction<sup>5</sup> period</b>	<b>Regulated Asset Value period<sup>6</sup></b>
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.

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<sup>5</sup> In the licence this term is referred to as the 'incentive period' and also as 'the TIRG relevant years'

<sup>6</sup> <https://www.ofgem.gov.uk/ofgem-publications/48279/glossary.pdf>

## Appendix 2 – Adjustment for historical revenue

The January consultation incorrectly referenced the post-construction revenues as having been set by our determination to provide additional funding for the project on 25 November 2010. At this stage the post-construction revenues were not updated to reflect the change in funding during the construction period. This means that during the post-construction period, SPT has been recovering lower revenues on the project than it should have been. Table 1 below sets out what the post construction revenues have been and what they should have been.

**Table 1 – Difference between post-construction revenue based on original forecast costs in the licence and amended costs from Asset Value adjusting event<sup>7</sup>**

	2010/11	2011/12	2012/13	2013/14	2014/15
OAV – As per licence (£k)	14,403				
OAV – This decision (£k)	19,366				
Revenue received (£m)	1.957	1.893	1.869	1.804	1.739
Revenue that should have been received (£m)	2.631	2.546	2.513	2.426	2.339
Revenue gap (£m)	0.674	0.653	0.644	0.622	0.600

Within an individual year it is unlikely that a TO will recover exactly the revenue its licence allows for. For this reason, the calculation of allowed revenue in part B of Special Condition 3A of SPT’s licence includes the  $K_t$  term. This term operates as a “correction factor” to annual revenues for over/under recoveries in previous years. This “correction factor” rolls all historical over or under recovery into an adjustment to the current year’s allowed revenue allowance. Depending on how far the collected revenue differs from SPT’s allowed revenue, it adds on specific levels of interest when consolidating the difference into the current year.

The  $K_t$  term operates through the revenue return model. This return is submitted on an annual basis by each Transmission Owner. It provides us with both the breakdown of its allowed revenue for the year, and the level actually received from customers. The restatement of allowed TIRG revenues will alter SPT’s historical under or over recovery position in the relevant years. The rolling correction factor will then automatically adjust SPT’s forward-looking revenue allowances for 2016/17 to reflect the the additional revenue that should have been recovered over the last 5 years for the sloy project.

<sup>7</sup> All revenue values presented are in 2009/10 prices

## Appendix 3 – Assessment of project against Opening Asset Value criteria

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 determination of SPT's OAV for project Sloy.

### *Asset Value Adjusting Event*

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

1. Site-specific civil works
2. Site-specific overhead line works
3. Distribution circuit crossings

In November 2010<sup>9</sup>, we approved the AVAE which increased the forecast cost to £19.6 million.

### *Efficiency of costs incurred*

In reaching our initial view of the opening asset value, we took into consideration that SPT incurred a final aggregate expenditure of £15.2 million for the Sloy project against an expenditure allowance of £19.6 million. We considered 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. Having reviewed responses to the consultation, we have not changed our view.

We also challenged SPT on why the realised cost savings had not been factored in as reductions to its AVAE submission in 2008. SPT 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 SPT at the time of its AVAE submission seemed the most effective for the complications faced; particularly as it was 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.

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<sup>8</sup> 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.

<sup>9</sup> <https://www.ofgem.gov.uk/ofgem-publications/52623/tirg-sloy-sp-november-25-2.pdf>

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

*Compliance with project-specific outputs*

In our January consultation, we set out our view that SPT fulfilled its output obligations under the TIRG licence condition in 2009-10. This is despite the fact that the full benefit of the increased outputs was not realised until the substation become operational in 2011-12.

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