



Making a positive difference
for energy consumers

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Additional conditions on Ofgem's 22/04/14 determination on Scottish Hydro Electric Power Distribution plc's (SHEPD) submission under Charging Restriction (CRC) 2Q (formerly CRC 18A)

Dear Robert,

Thank you for your letter of the 6 April 2016, setting out that you will need an additional three weeks, from your previous Invitation to Tender (ITT) issue date of 22 April 2016, to issue the ITT on the 13 May 2016 for the competitive process to identify the most efficient energy solution for Shetland.

We would agree that there has been improved progress since the appointment of Mott MacDonald, whom you have brought in to assist you with the drafting of the ITT, along with the input that you are now receiving from Baringa, and we hope that this momentum can be maintained.

Notwithstanding the most recent delay in the ITT issue date, we are concerned that the overall delays in the competitive process span more than a year. We are concerned about the impact that further delays could have on the timeliness and cost effectiveness of finding and implementing a new energy solution for Shetland.

In light of these concerns, this letter sets out a series of additional conditions that we are imposing on SHEPD under CRC 2Q.18. It is important that these new timelines (as per your letter dated 6 April 2016) are adhered to and we, in conjunction with the Independent Auditor, will be closely monitoring your progress in meeting these milestones.

The background to this issue and our concerns are outlined in Sections 1 and 2. The additional conditions are outlined in Section 3.

1. Licence requirements and background

In April 2014 we sent you a determination letter¹ outlining our decision to reject your proposed Incentive Mechanism (IM), and setting out requirements in respect of an open, fair and transparent competitive process. As you will recall, the background to that letter was as follows:

- 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. However, no IM was submitted.

¹https://www.ofgem.gov.uk/sites/default/files/docs/2014/04/ofgem_determination_of_shepd_submission_under_crc18a_0.pdf

- On 19 September 2013, we extended the deadline for you to propose the relevant IM (as specified in CRC18A.11²) so that you could comply with the licence condition and serve a valid Notice as required by CRC18A.11.
- You submitted the “Shetland Integrated Plan Proposed Funding and Incentive Mechanisms” on 23 December 2013, and you proposed an IM and a Cost Benefit Analysis (CBA) as an attachment to the Integrated Plan. At that stage in the process, we concluded you had complied with the minimum requirements under the licence.
- Based on our review and careful consideration of the documents, and having considered a report by our independent consultants, DNV GL, we rejected your proposed IM. We set out our reasons for this in our determination letter on 22 April 2014. In particular, we were not convinced that the relevant IM adequately incentivised the reduction of long-term costs. We were also concerned that your proposed costs were higher than expected. We considered that you had not sufficiently tested the market and that potential solutions were not adequately assessed.
- Therefore, we set out relevant conditions attached to our determination in order to facilitate an open, fair and transparent competitive process. A summary of the relevant conditions you were required to fulfil is set out below:
 1. You were asked to provide a nomination for an Independent Auditor, experienced in competitive procurement, including of power generation, who would be appointed to oversee, agree and report to us on the competitive process.
 2. You were asked to oversee an open and public consultation process, to precede the competitive process, to ensure that potential solutions and stakeholder considerations had been adequately explored.
 3. You were required to run a competitive process to identify the most efficient solution for Shetland.
 4. You were informed that cost efficiency should be ensured and encouraged for the short, medium and long term through an IM, which also needed to be informed by the results of the competitive process.
 5. After this two-stage approach, including a public consultation and an open competitive process, you were required to submit for our approval the RA for the incentivised costs of the Integrated Plan. We expected you to submit the RA within approximately 12 months of that decision letter.

2. Competitive process to date and reasons for concern

There have been significant delays in the competitive process, for a variety of reasons, some of which we consider could easily have been avoided. As a result, we are concerned that the competitive process, as it is currently being pursued, risks not delivering an efficient solution for Shetland. In particular, we are concerned that further material delay is likely to reduce the ability of some potential bidders to deliver a solution by the deadline you have set or that costs could increase for solutions to meet the deadline. As a consequence, there is a real risk that consumers could be adversely affected.

The 22 April 2014 determination letter set out an expectation that the process would take approximately 12 months from 22 April 2014, but allowed for the timelines to be further discussed and agreed. You have revised several plans or timelines to manage the competitive process which have shown significant variation to the initial milestones. Furthermore, between April and September 2015 we made several requests for an updated project plan, but you were unable to provide us with this.

We do not consider that the delay in issuing the ITT, first to June 2015, then to January 2016, and finally to May 2016 has been fully justified.

When we have raised concerns over the delays in previous discussions, you have suggested that the delays are due to a combination of reasons including;

² In the latest price control RII0-ED1, the reference CRC 18A has been updated to CRC 2Q

- Determining a suitable methodology by which to assess what is a complicated tender;
- Insufficient resourcing of the project by SHEPD to ensure a timely delivery of the ITT; and
- Inability of SHEPD and Ofgem to come to an agreement on the demand forecast and other outputs of the assessment process.

We do not consider these to provide justification for the extent of the delays that have thus been encountered. We understand and appreciate that the tender has complex features, but we consider that SHEPD has had sufficient time, and should have the capability, to carry out such a tender. We have also provided you with mechanisms through the RII0- ED1 price control to fund additional resource if it is needed. In fact, we understand that SHEPD has now procured additional external resource to assist with this process, albeit only after significant delays have occurred. Moreover, we think the demand forecasting analysis was not robust in its earlier iterations – we think this is evidenced by SHEPD reducing its forecast of peak demand by almost 40% since March 2015.

Against this background, we are concerned to ensure that the process is not delayed any further. Our concerns are outlined below.

Overall delays and impact on competitiveness

Whilst we have seen recent improvement, we are very concerned by the delays overall and SHEPD's ability to maintain the agreed timescales. As stated in our determination letter of April 2014, *"we currently expect that you will submit this (the RA for the incentivised costs of the Integrated Plan) to us within approximately 12 months of this decision. However, we will continue to work with you to firm up the relevant timetable."*

We were therefore expecting the competitive process to be completed (contract award) by April 2015. You have since made a number of changes to your project plan and issued a number of revised iterations which have resulted in contract award now being estimated for Q2 2017. We are disappointed that you have yet to begin the ITT part of this process.

The significant delay ahead of awarding the contract is putting pressure on the bidders' ability to commission and build the new energy solution for Shetland to meet the Commercial Operation Date (COD), currently the end of 2019, and to have the relevant consents in place by contract award (Q2 2017). Moreover, ongoing delays in the competitive process create uncertainty, and risk the withdrawal of further bidders from the process.

We asked you to contact bidders in December 2015 and alert them to the revised timetable, as well as asking them how the shortened timescales would impact their ability to meet the 2019 COD. You informed us that some of the bidders may not be able to meet the 2019 COD.

This information strengthened our concerns that ongoing delays are likely to disadvantage some potential bidders more than others, with obvious deleterious consequences for the competitive process. Our decision letter clearly set out the relevant requirements to run an open, fair and transparent competition, and we remind SHEPD that all licensees have an obligation to facilitate competition in the supply and generation of electricity under the Electricity Act 1989.

In addition, we requested that you contact the Scottish Environment Protection Agency (SEPA) and explore options for extending the operation of Lerwick Power Station (LPS) beyond 2019. You have recently informed us of SEPA's firm indication that LPS could be operated until the end of 2020³. We further understand there could be a reasonable likelihood of operating LPS beyond this date without incurring SEPA enforcement action in the short term, if it can be demonstrated that a compliant alternative solution is being pursued.

3. Relevant additional conditions attached to our determination

Given the extensive delays that have occurred we consider that it is necessary to issue additional conditions, supplementary to those previously imposed upon you under our decision letter of 22 April 2014. We have determined these conditions because it is necessary to set out specific milestones which we expect you to achieve within defined timeframes. These are set out below:

³ This extension of the operating deadline of LPS is nevertheless dependent on the results of engineering report assessment of the costs of running LPS beyond 2019.

a) Providing a robust demand forecast and suitable security of supply assessment

- (i) All reasonable efforts are to be made to ensure that a robust and comprehensive demand forecast and security of supply standard is agreed and finalised by the Independent Auditor and SHEPD, and presented to Ofgem for its agreement in advance of issuing the ITT. We are now hopeful that you will be able to meet this deadline.
- (ii) You will assess the security of supply options based on an economic evaluation of Loss of Load Expectation of 3-8 hr in order to assess solutions against cost as part of the tender assessment process prior to making your recommendation to Ofgem in January 2017.

b) Overall delays and impact on competitiveness

- (i) As previously agreed, you will carry out an assessment of the condition of LPS, including a cost assessment of extending the life of the plant. That assessment shall be audited and approved by the Independent Auditor. This assessment and audit will be completed by 13 May 2016.
- (ii) Should the report in (i) deem the extension of LPS operating beyond 2019 to not be viable, you will commission and deliver an independent assessment of options and costs of suitable contingency arrangements for Shetland for the interim period, for those solutions that may not be operational by the COD. This report should be delivered by the issue of the ITT. The options and length of the interim period will be informed by the assessment and audit referred to at (i).
- (iii) You will clearly present in the ITT the costs agreed by the independent third party and explain how they will be used in the assessment process in the event that a bidder cannot meet the COD date.
- (iv) Supported by evidence from (i) and (ii) above, and in light of the recent indication from SEPA that LPS could operate to the end of 2020, you will consider the most appropriate COD date to deliver the best value for consumers. We would expect you to write to us at the earliest opportunity confirming this decision. This decision will clearly be evidenced and justified and set out in the ITT.

We also set out the following milestones (as per your letter dated 6 April 2016) that you must complete alongside input and agreement from the Independent Auditor. If these are not completed within the times stated below⁴, we will need to consider further action, and in particular to consider whether (i) you will be in breach of these supplemental conditions, which in turn arise from CRC2Q.18, and consequently will be in breach of CRC 2Q.18 and/or (ii) you will have failed to comply with your statutory duty, under section 9 (1)(b) of the Electricity Act 1989, "to facilitate competition in the supply and generation of electricity."

Table 1

ITT Milestone	Required date
Pre-ITT Tenderer Conference	April 2016
ITT Issue date	13 May 2016
Tender Submission (by noon deadline)	7 October 2016
Tender Compliance Evaluation completed	November 2016
Commercial Evaluation of Tenders completed	January 2017
Award Recommendation submitted to Ofgem for approval	January 2017
Contracts Awarded	Quarter 2 2017

SHEPD is required to fulfil the steps set out in this determination by the dates specified. If SHEPD considers it will not be able to meet any of these time limits, it must notify the Authority as soon as it becomes aware of the relevant circumstances, setting out the cause and length of the anticipated delay and what steps it is taking to

⁴ These dates are subject to change, should the COD change beyond 2019, if this is the case SHEPD should immediately publish the revised dates.

mitigate the delay. On receipt of such notification, the Authority will consider whether to extend the time limit. For the avoidance of doubt, the Authority will not extend any date unless it considers it necessary and appropriate to do so.

Where the process set out in this determination requires action to be taken by the Authority, the Authority will undertake the necessary steps as soon as reasonably practicable. Where the Authority considers it requires additional time to undertake any action it will notify SHEPD at the earliest opportunity, setting out the reasons why further time is required.

4. Next steps

We remain keen to work with you throughout this process to ensure that it is fair and transparent process and that the most efficient solution for Shetland is identified and pursued. We expect you to meet these milestones without further delay.

Yours sincerely,

Kersti Berge
Partner
Networks