

To: Interested parties

Date: 25 August 2017

Consultation on our minded-to position to revise Scottish Hydro Electric Power Distribution (SHEPD)'s allowed expenditure for the Shetland New Energy Solution Competitive Process Costs (CPC) under special licence condition CRC 3F

Ofgem introduced a number of uncertainty mechanisms for costs that were uncertain at the time of establishing the first RIIIO electricity distribution price control (RIIO-ED1), which runs from 1 April 2015 to 31 March 2023. This includes re-opener mechanisms, which enable adjustments (up or down) to electricity distribution network operators' allowances to accommodate costs associated with specific uncertain cost categories. These mechanisms are set out in Special Condition CRC 3F¹ of the Electricity Distribution Licence.

The costs associated with designing and implementing a competitive process to identify an enduring New Energy Solution (NES)² in Shetland, known as Shetland Competitive Process Costs, was one such uncertain cost category specific to the SHEPD licence.³ The term Shetland Competitive Process Costs means costs incurred, or expected to be incurred in implementing the competitive process referred to in the Authority's open letter dated 22 April 2014⁴, to the extent that those costs are not otherwise recoverable under the licence. The costs relate to:

- a. the appointment and tasking of an independent auditor;
- b. a public consultation process; and
- c. a competitive tender process for the design of the enduring solution for Shetland.

SHEPD has confirmed to Ofgem that it will incur costs that are above the set materiality threshold (£0.1 million)⁵. Total costs incurred from 2015/16 to 2017/18 will be £2.91 million (in 2012/13 prices). SHEPD received a baseline allowance of £1.03m and are seeking to recover the additional £1.88m.

Based on our review of SHEPD's application, and subject to consideration of consultation responses, our view is that the costs presented by SHEPD are efficient and we propose to adjust SHEPD's allowances by the full £1.88m. Detail is set out in Appendix 1.

¹ Charge Restriction Condition 3F: Arrangements for the recovery of uncertain costs.

² Details on the Shetland NES can be found here: <https://www.ofgem.gov.uk/publications-and-updates/consultation-cost-new-energy-solution-shetland>

³ The process was established by Ofgem in our Determination Letter <https://www.ofgem.gov.uk/ofgem-publications/87381/ofgemdeterminationofshepds submissionundercrc18a.pdf>

⁴ <https://www.ofgem.gov.uk/ofgem-publications/87381/ofgemdeterminationofshepds submissionundercrc18a.pdf>

⁵ As specified in Appendix 7 to CRC 3F of the special licence conditions.

We would like to hear the views of interested parties in relation to our minded-to position for adjusting the allowances associated with the Shetland Competitive Process Costs set out in this open letter. We would especially welcome responses to the specific question:

Do you agree with Ofgem's assessment and the proposed adjustment to SHEPD's Opening level of allowed expenditure for Shetland Competitive Process Costs?

Responses should be received by **22 September 2017** and sent to:

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Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response, or part of response, is kept confidential. We shall respect this request, subject to any obligation to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and/or in writing.

Yours sincerely,

SIGNED on 24 August 2017

Steven McMahon
Associate Partner, RIIO Networks

Appendix 1: Methodology

Set out in this appendix are our current views, which are subject to consideration of consultation responses.

Following this consultation, the Authority will determine if the application complies with CRC 3F, whether any or all of the costs were or are likely to be efficiently incurred, and any adjustment to allowances.

Step 1: Compliance with CRC 3F

We consider that in its application, SHEPD has demonstrated that it complies with all the requirements under CRC 3F and we are satisfied that:

- the costs submitted are based on auditable evidence and justification, and were not included in SHEPD's Opening Base Revenue Allowances;
- there were no previous adjustments under this conditions that should be taken into account;
- the costs submitted constitute a material amount⁶;
- the costs submitted were incurred or are expected to be incurred after 1 April 2015;
- the costs submitted constitute an adjustment to allowed expenditure that cannot be made under the provisions of any other condition in the SHEPD licence; and
- the application includes statements setting out:
 - the uncertain cost category to which the proposal relate
 - the changes to SHEPD's allowed level of expenditure that are proposed and the Regulatory Years to which those changes relate
 - the basis of calculation for the changes to SHEPD's allowed level of expenditure.

Step 2: Cost efficiency assessment

It is usual practice in reaching our view of efficient costs to benchmark across the industry. As the running of a competitive process was unique to SHEPD this has not been possible. As such, our analysis in this case is based on our scrutiny of the information submitted by SHEPD.

As noted above, the key activities that comprised the Competitive Process were:

- a. the appointment and tasking of an independent auditor;
- b. running a public consultation process to raise awareness of, and promote discussion about, the energy need in Shetland and to make sure all potential solutions and stakeholder considerations have been explored; and
- c. running a competitive tender process for the design of the enduring New Energy Solution for Shetland.

The costs incurred in successfully delivering the above tasks were mainly human resource costs – the costs of working with people with the necessary technical, commercial, legal, economic and project management expertise. Each professional area used is set out in Table 1, alongside the cost incurred, their role and our current view on how cost efficiency was demonstrated.

The SHEPD application included a detailed narrative, copies of contracts, summarised breakdown structures of all the work areas, as well as the agreed outputs of the

⁶ As specified in table of Appendix 7 of CRC 3F.

individual work areas. We found the application to be of sufficient quality to undertake an assessment.

After the initial review, we raised a number of supplementary questions to probe in more detail on the costs. All the supplementary questions were answered and additional commentary as well as supporting documentation has been provided to a satisfactory detail and quality.

Ofgem was kept up to date with the progress of the competitive process and we have had the opportunity to provide some input in terms of running the process. This fact has allowed us to have confidence in the efficiency of the overall level of costs associated with the appointment and tasking of an independent auditor, a public consultation process and a competitive tender process for the design of the enduring solution for Shetland.

Table 1: Cost by work area

Cost driver	£ (nominal)*	Ofgem view of cost efficiency
Independent Auditor Primary role: work alongside SHEPD and Ofgem to ensure the Competitive Process was open, fair and equitable.	66,000	Cost efficiency demonstrated by: recruitment via an open ITT.
Legal advisor Primary role: developing a full set of bespoke draft agreements for each tender lot of the enduring energy solution.	1,113,000	Cost efficiency demonstrated by: appointment via SSEN's legal panel, which required them to go through a competitive process; and movement from time and expenses basis to capped price solution as soon as a clear service scope could be developed.
System analysis consultant Primary role: providing technical support in demand forecasting, network system modelling and security of supply analysis to size the capacity and energy solution for the Shetland NES.	246,000	Cost efficiency demonstrated by: day rate lower than closest alternative framework consultant and justification due to the specialist nature of work for being subject to a competitive process.
Technical consultant Primary role: engineering and technical assurance support for a complex project.	569,000	Cost efficiency demonstrated by: appointment via SSEN's supplier panel, which required them to go through a competitive process; and movement from time and expenses basis to capped price solution as soon as a clear service scope could be developed.
Commercial evaluation consultant Primary role: to ensure a robust third party assessment of the economics of the tender submissions.	126,000	Cost efficiency demonstrated by: recruitment via an open ITT and fixed fee from the outset.
Project Management – external Primary role: dedicated project manager to ensure the tender process that led to the SNES was successful and delivered on time.	497,000	Cost efficiency demonstrated by: favourable comparison to other existing/past project management framework agreements and one-off contracts.
Project resources – internal	502,000	Cost efficiency demonstrated by: making best use of existing resources without the

Primary role: current specialist SHEPD staff who were removed from previous roles to work largely on the competitive process. They provided support in the following areas: project management, legal, procurement and regulation.		need to retrain or go through a recruitment process.
Other miscellaneous costs	25,000	These include cost of consultation event facilities and the design and production of communication materials.
Total	3,144,000	
Total (12/13 prices)	2,914,000	Cost efficiency demonstrated by: actual costs less than forecast costs of £4,088,000 in 2014.

*prices recorded in the price base of the year they are incurred.

Step 3: Proposed adjusted CPC allowances

Based on the above, and the fact that any concerns or supplementary questions raised by Ofgem have been answered, we propose to accept the adjustment to SHEPD's opening level of allowed expenditure for Shetland Competitive Process Costs from £1.03m to £2.91m. Table 2 provides the profile of the opening and proposed CPC allowances.

Table 2: CPC expenditure profiles (£, 2012/13 prices)

	Opening CPC allowances	Proposed adjusted CPC allowances
2015/16	1,030,000	600,000
2016/17	0	1,270,000
2017/18	0	1,040,000
2018/19	0	0
2019/20	0	0
2020/21	0	0
2021/22	0	0
2022/23	0	0
Total	1,030,000	2,910,000