

James Norman
Head of New Transmission
Investment
Ofgem
10 South Colonnade
London
E14 4PU

Date
31 May 2019
Contact / Extension
**Lynne Bryceland
0141 614 3124**

Dear James

Shetland transmission project: Consultation on Final Needs Case and Delivery Model

This response is from SP Transmission (SPT), the onshore transmission owner (TO) for the South of Scotland. As a TO, we have a duty to ensure that we develop and maintain an economic, efficient and coordinated onshore transmission system. We therefore welcome the opportunity to share our views on the Final Needs Case and delivery model for SHE-T's 600MW subsea cable between Shetland and the mainland. Given Ofgem's forthcoming informal consultation on the proposed generic CPM licence conditions, which we will respond to with our detailed thoughts on the principle and application of the CPM framework, we have primarily restricted our views in this response to Ofgem's decision on the Final Needs Case and Delivery model for the Shetland project.

We are in agreement with Ofgem that the Shetland project meets the competition criteria of new, separable and high value (i.e. > £100m capital expenditure) and that Ofgem should approve the Final Needs Case for this transmission connection, given its necessity to unlock the renewable energy potential on the Shetland Isles. We also agree with Ofgem that the securing of a Contract for Difference (CfD) in the CfD auction later this year, is a strong indication of the project's likelihood to be developed. However, we cannot agree with Ofgem's decision that this strategic infrastructure project should be delivered under Ofgem's new Competition Proxy Model (CPM) framework.

SPT continues to hold the view that the proposed CPM delivery model is unlawful, unworkable in practice and in no way delivers the stated aim of extending competition across the GB onshore transmission system. Surprisingly, Ofgem has yet to present a standalone CPM policy setting out the details of the CPM mechanism. Instead it has chosen to develop the CPM framework through National Grid Electricity Transmission's (NGET) Hinkley Seabank project, and subsequently Scottish Hydro Electric Transmission's (SHE-T) Orkney, Shetland and Western Isles subsea link projects. There is therefore a lack of understanding as to the scope of the CPM mechanism and how it will interact with the current or future price control frameworks. We also consider that the reopening of the RIIO-T1 price control in this way will undoubtedly damage regulatory certainty and investor confidence.

Given that the need for this subsea link is driven by the Viking Energy Wind Farm, it is fundamentally important that the ongoing work to develop a complete and coherent CPM policy, including licence conditions to implement it, does not delay SHE-T's timetable for delivery of this project in Q1 2024. It is also important to investors, generators and communities alike, that the development of this new delivery model does not complicate or delay the delivery plans for strategic transmission infrastructure.

SP House, 320 St Vincent Street, Glasgow. G2 5AD

Telephone: 0141 614 5213

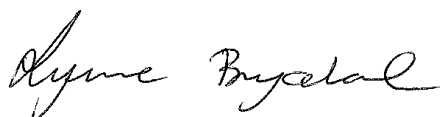
www.spenergynetworks.co.uk

We therefore consider that Ofgem should do what it originally said it would do during RII0-1 and approve the Shetland project for delivery under the RII0 Strategic Wider Works (SWW) delivery model. The SWW framework is the mechanism specifically designed to support large scale strategic infrastructure investments, such as this Shetland project, under the current price control framework.

As per the arguments above, we remain strongly of the view that the Shetland project should be delivered under the existing RII0 SWW framework. This would allow Ofgem to focus its time and resources on the future RII0-2 price control, engaging directly with key stakeholders as to how it intends to effectively facilitate true competition across this future framework, balancing the long-terms interests of investors and consumers alike.

We continue to reserve all our rights, including those under the Electricity Act 1989. However, should you have any questions in relation to this response, please do not hesitate to contact me.

Yours sincerely



Lynne Bryceland
Transmission Policy and Licence Manager

SP House, 320 St Vincent Street, Glasgow. G2 5AD

Telephone: 0141 614 5213

www.spenergynetworks.co.uk

SP Transmission plc, Registered Office: Ochil House, Technology Avenue, Blantyre, G72 0HT Registered in Scotland No. 189126 Vat No. GB 659 3720 08
SP Manweb plc, Registered Office: 3 Prenton Way, Prenton, CH43 3ET Registered in England and Wales No. 2366937 Vat No. GB659 3720 08
SP Distribution plc, Registered Office: Ochil House, Technology Avenue, Blantyre, G72 0HT Registered in Scotland No. 189125 Vat No. GB 659 3720 08

ANNEX

Shetland transmission project: Consultation on Final Needs Case and Delivery Model
SP Transmission's response to consultation questions

Q1: Do you agree that the current network on Shetland Isles needs reinforcing in order to connect additional generation?

We understand that the Shetland Isles are currently served by a 33kV distribution network, independent of the main GB electricity system. We also understand that due to the constraints on the existing network, SHEPD is currently not allowed to connect any new generation on the island's distribution network. As suggested in the consultation document, we would expect the Viking Energy Wind Farm to participate in the forthcoming Contract for Difference (CfD) which will include Remote Island Wind (RIW).

We would therefore agree that the current network needs to be reinforced, in order to facilitate the economic integration of additional renewable generation located on the Shetland Isles.

Q2: What are your views on the generation scenarios developed by SHE-T? We are particularly interested in views on the likelihood of wind generation on the Shetland Isles developing to the levels predicted by SHE-T's scenarios.

SPT does not have sufficient knowledge of the specific projects proposed to connect in this region to respond to this question.

Q3: What are your views on SHE-T's approach to optioneering, are there other options that SHE-T should have considered?

The proposed transmission connection between Shetland and mainland Scotland has been developed by SHE-T over a considerable period of time.

In evaluating alternatives and developing the proposed solution, SHE-T has considered a range of potential landing points on the Scottish mainland, as well as a range of HVDC link capacities consistent with the potential for renewable generation development on the Shetland Isles.

The proposed reinforcement option builds on the strategic platform provided by the detailed design, specification and implementation of the Caithness-Moray HVDC link. The proposed Shetland link is based on the use of HVDC subsea cable technology, similar to that used on the Caithness - Moray project, which was commissioned in 2018/19. SHE-T is therefore well placed to understand the capability, costs and risks associated with the design, development and delivery of a project of this nature.

Ofgem has highlighted that SHE-T prioritised the development of its proposed option prior to submission of the Final Needs Case. We understand this to be consistent with Ofgem's Strategic Wider Works (SWW) Guidance, and agree that it is neither feasible or desirable to progress all transmission reinforcement options to a common level prior to the Final Needs Case process.

SP House, 320 St Vincent Street, Glasgow. G2 5AD

Telephone: 0141 614 5213

www.spenergynetworks.co.uk

Q4: What are your views on the CBA put forward by the ESO?

We question why the decision was taken to exclude the steady state scenario from the CBA modelling for the Shetland project, yet include it in the Western Isles project, even though this scenario was lower than the minimum renewable threshold for constructing the link. It is important that there is consistency of approach in relation to the CBA modelling across different projects, particularly of a similar nature, such as Shetland and the Western Isles.

We do however accept and support the methodology of the CBA in terms of capex against the avoided constraint costs. However, we consider that this must not be the sole mechanism for making decisions in cases where there is circularity over need and generation potential, as it is clear that both the Shetland Isles and Western Isles have significant renewable potential to be exploited.

Q5: What are your views on the technical design and costs of the proposed Shetland link?

We would expect SHE-T to be prudent in their costs, derived from credible suppliers and a detailed technical assessment of their offers. Given the volume of projects in which SHE-T are involved in, we would consider that their supply chain management and tender processes will result in efficient costs. The proposed HVDC link is based on the use of HVDC subsea cable technology, similar to that used on the Caithness - Moray project, which was commissioned in 2018/19. SHE-T is therefore well placed to understand the capability, costs and risks associated with the design, development and delivery of a project of this nature.

Q6. What are your views on our minded-to position to conditionally approve the Needs Case? Specifically do you agree with our proposal to approve a 600MW link if Viking Energy Wind Farm secures a CfD in 2019?

Yes, we agree that the award of a CfD to a generator offers sufficient certainty that the generator will progress to full commissioning, particularly as the forthcoming CfD round in 2019, which allows RIW to complete for Pot 2 funding, is the result of a Government policy which recognises the benefits of projects on remote islands, including Shetland.

Q7. Do you agree with our assessment of the Shetland project against the criteria for competition?

Yes, we agree with Ofgem's assessment that the Shetland project meets the criteria for competition of new, separable and high value (> £100m capital expenditure).

Q8. Do you agree with our proposal not to competitively tender the Shetland project using the SPV model or under our CATO framework unless there are significant delays to the delivery timescales?

It is important that the introduction of new competition models, does not result in delays to the delivery of large scale transmission projects. As we set out in our response to Ofgem's September 2018 SPV

consultation, we do not consider the SPV model to be lawful, practical or cost effective. We therefore agree that the Shetland project cannot be delivered under it. Further, as the relevant legislation which Ofgem has said it requires for the CATO model is not in place, the Shetland project cannot be subjected to this delivery model.

However, it does not follow that the Shetland project should be delivered under CPM. As set out in our covering letter, we also consider the CPM delivery model to be unlawful, unworkable in practice and fails to deliver the stated aim of extending competition across the GB onshore transmission system.

Q9. Do you agree that the Competition Proxy Model would deliver a favourable outcome for consumers relative to the status quo RIIO SWW delivery arrangements?

We do not agree that CPM will deliver favourable outcomes for consumers relative to the existing SWW delivery arrangements. As we have repeatedly argued and elaborate in our covering letter, CPM is neither competition nor lawful nor efficient regulation.

We question the proposed £6 - £43m savings to consumers for this project, as a project specific impact assessment and cost benefit analysis has not been undertaken, and consulted upon, for delivery of the Shetland project under the CPM framework. We continue to be of the view that if Ofgem intends to deliver strategic infrastructure projects, under their new competition models, then a project specific impact assessment and cost benefit analysis should be undertaken, in advance of Ofgem deciding on the competition model to be adopted for project delivery.

We would ask that Ofgem set out, in further detail, as to how the proposed £6 - £43m consumer savings figures have been derived. We also ask Ofgem to fully address the various concerns with its proposed CPM policy which we and others have raised to date.

Q10. What are your views on the way in which we have applied project specific updates to the Competition Proxy Model methodology to account for the specific characteristics of the Shetland project?

As per our earlier correspondence to Ofgem on CPM, SPT continues to hold the view that the proposed CPM delivery model is unlawful, unworkable in practice and in no way delivers the stated aim of extending competition across the GB onshore transmission system. We consider that the CPM methodology is flawed, in particular, as it uses inaccurate and inconsistent cost of capital assumptions.

Whilst we have set out our views on Ofgem's project specific updates to the CPM methodology for the Western Isles project, we note that Ofgem's latest annual update to the "Decision on Interest During Construction (IDC) rates to be applied during 2019-20 to offshore transmission projects and electricity interconnectors granted the cap and floor regime", dated 30 May 2019, does not include revised rates for CPM. Our views below are therefore based on the CPM rates which reflect September 2017 market rates, which we consider to be significantly outdated.

Benchmark for Cost of Debt during construction

We are not supportive of Ofgem's decision to use the A-rated iBoxx GBP corporate index as the benchmark for the bottom end of their cost of debt range during construction for the Shetland project. The utilisation of this index risks understating the cost of debt allowance as it does not adequately reflect the construction risk related to the Shetland project.

For HSB, Ofgem and CEPA both accepted that the A-rated credit rating assumption for the project under the CPM deliver model would be challenging, and therefore, revised their approach to instead rely on the BBB iBoxx 5-7yr index, as this better reflected the additional risks associated with the project during construction and was supported by precedent (e.g. Thames Tideway Tunnel, PNG and Firmus cost of debt allowance is based on BBB). Ofgem utilise an A-rated benchmark due to their perception that the Shetland project is exposed to similar technology and construction challenges as those faced by new interconnector links. However it is inconsistent for Ofgem to then assume that the Shetland project could achieve a higher credit quality than HSB during construction, given Ofgem's acceptance that the Shetland project reflects greater capex risk due to their acknowledgement in their beta assessment that the construction of an offshore transmission asset would face additional marine-based construction risks that are not applicable to onshore construction work. In this regard, we consider that the BBB credit rating applied to HSB and comparable projects would be a rational starting point for the Shetland project.

Additionally, as outlined in more detail below, the omission of allowed cash-flows, during Shetland's construction, to recover debt cost will negatively affect credit metrics. Thus will have a detrimental effect on the project's credit profile, further limiting the project being able to achieve an A credit rating. For the above reasons there is no apparent basis on which Ofgem is proposing to assume a better credit quality for Shetland, when compared to HSB. We are therefore of the opinion that it would be more appropriate to assess the cost of debt allowance for Shetland with reference to a BBB-rated benchmark only.

Benchmark for Cost of Debt during operational period

As in HSB, we are not supportive of Ofgem's use of the iBoxx corporate non-financial indices with 10+ years maturity as the benchmark for the cost of debt during the operational period for the Shetland project.

Similar to our concerns for the cost of debt during construction, the A-rated credit rating assumption used by Ofgem for the benchmark for the bottom end of their cost of debt range during the operational period is inconsistent with the 85% gearing assumption used in the bottom end. It is contentious to assume that a highly leveraged financial structure, like that proposed by Ofgem for the operational period, has the ability to achieve an A rating given the rating methodologies applied by credit rating agencies such as Moody's¹. On the other hand a notional gearing assumption of around 60%, which is in line with the corporate financed onshore TOs, is consistent with an A/BBB rating assumption. Secondly, as highlighted by NERA², when selecting a benchmark index for the cost of debt, the average remaining tenor of the constituent bonds should match the length of the operational phase

¹ According to Moody's rating methodology, Baa rated utilities should have a gearing of 60-75% and A rated utilities of 45-60%, far below Ofgem's assumed 85%, or indeed 80%, gearing assumption for the operational period. See: Moody's (March 2017), Regulated Electric and Gas Networks, Rating Methodology, p.19.

period, which is also the expected tenor at issuance for the CPM. The 10+ years iBoxx has a remaining maturity of around 21 years, which is shorter than the length of the operational period of 25 years. The correct index in this case would be the 15+ years iBoxx index as it has a remaining maturity of around 26 years which more closely matches the length of the operational period of 25 years.

For the above reasons, we are of the opinion that it would, amongst other things, be more appropriate to assess the cost of debt allowance for Shetland during the operational period with reference to the A/BBB 15+ years iBoxx index.

Uplift to the Beta

Although we recognise Ofgem's inclusion of an uplift to the upper end of the asset beta for the Shetland project, relative to HSB, as this decision recognises the project's exposure to additional specific risks associated with marine-based construction, we find that the approach employed by Ofgem to determine the uplift for Shetland is unsuitable for the asset in question.

The rationale for the uplift on the high end of the CPM construction asset beta is the recognition that the specific challenges during construction in a marine environment are not faced by the representative onshore construction and engineering comparators used in the CPM asset beta estimation. Ofgem consider that the uplift applied to OFTO and interconnectors, relative to HSB, is consistent with the Shetland project. The scale of this uplift is determined by CEPA on a purely qualitative basis through a relative risk assessment during the construction phase between CPM and the two offshore transmission regimes.

We believe that Ofgem's arbitrary uplift is based on an inherently subjective risk analysis between the various transmission regimes and the inclusion of this premium to account for marine construction risk has not been evidenced enough by CEPA to align with actual experience and that a different, more objective approach should instead be adopted for Shetland. CEPA even acknowledge in their "Review of Cost of Capital Ranges for New Assets for Ofgem's Networks Division" July 2018 report that if future offshore assets were to proceed under CPM, the analysis on setting the asset risk may need to be reviewed.³ We therefore recommend that Ofgem reconsider their commitment to this approach and examine alternative approaches⁴ that lead to greater objectivity in determining the risk differentiation between transmission regimes in order to ensure that the project specific risks associated with Shetland are adequately compensated for. Most obviously, it will be important to recognise that all OFTOs to date have taken on already built assets and therefore carry no construction risk.

Additionally, as highlighted in our response of March 2018 response to Ofgem's minded to decision for Hinkley Seabank we find that the lower bound of the range of the asset beta is understated due to the reliance on evidence from energy network companies. CEPA's evidence for the lower bound of the HSB asset beta range was based on the estimates from allowed asset beta for Scottish TOs at the RIIO-T1 price decision.

² NERA (2018), Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments: A report for SHET plc and SPT plc.

³ CEPA, 2018, report to Ofgem, "Review of Cost of Capital Ranges for new assets for Ofgem's Networks Division", Footnote 45

Revenue during construction

We are not supportive of Ofgem's decision on the removal of the allowance for revenues during the construction phase to recover debt cost of the Shetland project as its removal could impact on the financeability of the project on a standalone basis. The lack of interventions to reduce cash-flow limitations during construction could affect SHE-T's capacity to service the debt raised upfront and hence would limit the ability of achieving credit metrics that would ensure a stable investment grade credit rating, thereby increasing financing costs of the project and ultimately costs to consumers.

SP House, 320 St Vincent Street, Glasgow. G2 5AD

Telephone: 0141 614 5213

www.spenergynetworks.co.uk

SP Transmission plc, Registered Office: Ochil House, Technology Avenue, Blantyre, G72 0HT Registered in Scotland No. 189126 Vat No. GB 659 3720 08
SP Manweb plc, Registered Office: 3 Prenton Way, Prenton, CH43 3ET Registered in England and Wales No. 2366937 Vat No. GB659 3720 08
SP Distribution plc, Registered Office: Ochil House, Technology Avenue, Blantyre, G72 0HT Registered in Scotland No. 189125 Vat No. GB 659 3720 08