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Sent by email to: NTIMailbox@ofgem.gov.uk

Dear Cathryn,

Consultation on Scottish Hydro Electric Power Distribution's proposals to contribute towards proposed electricity transmission links to Shetland, Western Isles and Orkney

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

We welcome and encourage licensees developing coordinated solutions to network issues. Expenditure allowances, in totality, can be more efficiently utilised when coordinated solutions are progressed where appropriate. Licensees should be mindful of a fundamental premise that supports the concept of a whole system solution: "...it will be important to ensure that the energy system as a whole is effectively coordinated to deliver best value for consumers ('whole system outcomes')..."¹. Any coordinated solution should offer better value to consumers compared to solutions progressed independently by licensees.

We, however, raise concerns about Scottish Hydro Electric Power Distribution's (SHEPD's) proposals to contribute towards the proposed electricity transmission links. We recommend:

- **A full impact assessment of the consumer benefits of permitting contributions and of the enabling arrangements should be conducted, and its findings should be formally consulted on.**

This assessment should include consideration of the direct and wider implications and risks of the proposals, and of any changes to industry arrangements needed to enable the contributions to be made. Stakeholders should be formally consulted on the findings of the impact assessment

¹ "RIIO-2 framework consultation"; paragraph 4.26:
https://www.ofgem.gov.uk/system/files/docs/2018/03/rrio2_march_consultation_document_final_v1.pdf.
Page 1 of 7

before the decision on SHEPD's proposals is made. Established open governance arrangements should be utilised if any changes to industry arrangements are required.

Value for consumers:

It is not clear that permitting the contributions will deliver better value for consumers. Based on the information in this consultation and in the consultations on the Needs Cases, the links have been proposed to enable renewable output on the islands to be exported to mainland GB. It does not appear that the design of these links has been explicitly adapted to provide benefits to the distribution networks. Further, SHEPD has indicated there is no near-term, material or critical distribution need for the Western Isles or Orkney which a transmission link would meet².

Given the interconnectedness of the electricity system, a project delivered in a certain licence area can provide network benefits in another licence area without being specifically designed to do so. It has not been explained why it is necessary to consider contributions in a scenario in which exogenous benefits accrue from a project delivered by another licensee and that project has not been adapted for the 'benefiting' licensee. We do not believe SHEPD has yet justified why contributions are necessary.

SHEPD proposes the contributions are funded by an uplift on its Regulatory Asset Value (RAV)³. Given the differences in the financial parameters between baseline price control arrangements and the Competition Proxy Model (CPM), consumers would be required to provide a different level of funding, resulting in different baseline returns relative to that for a project funded entirely via the CPM. The baseline return required to remunerate investors for funding expenditure of these transmission links should be based on the associated risks rather than whether it is funded via different routes. We agree different financial arrangements for SHEPD's contributions should be considered if the contributions be permitted, including the treatment of any over-/under-spend of allowances and the appropriate allocation and remuneration of risk.

It is also important that SHEPD's proposals are considered in the context of other proposed and confirmed investments. For example, proposals for a transmission link (via the Strategic Wider Works mechanism) and a distribution link (via the 2019 electricity distribution reopener window) connecting Orkney to mainland GB have been submitted. Additionally, SHEPD recently received additional expenditure allowances of £ 122.8m to deliver the extended interim energy solution on Shetland⁴. These proposals should be considered holistically from the consumer perspective. Any allowances provided for the extended interim energy solution that will no longer be needed if the Shetland transmission link is approved should be returned to consumers.

Implementation and industry arrangements:

There is insufficient clarity about changes to industry arrangements needed to enable the contributions to be made, interactions with the ongoing network charging Significant Code Reviews and of any related consequences.

² Consultation document page 3.

³ Consultation document page 14.

⁴ "Decision on Costs for the Extended Interim Energy Solution for Shetland"; page 7:
https://www.ofgem.gov.uk/system/files/docs/2018/06/decision_on_shetland_interim_solution_-_final_1.pdf.

SHEPD considers “...for reason of simplicity and speed in the tight timescales, that a change of interpretation of the [Connection and Use of System Code] CUSC methodology for calculating local circuit charges would be sufficient...”⁵. We disagree. It is not appropriate to adopt a different interpretation without the CUSC being amended, or to adopt a different interpretation just because of expediency. Open governance arrangements apply to the CUSC and there is an established process for proposing and implementing changes. It is necessary to demonstrate that any proposed change to the CUSC better meets the relevant objectives. Further, a change proposal can be progressed via an accelerated timetable if meets the relevant criteria. Due process should be adhered to. In any event, Ofgem explains why it may be neither appropriate nor necessary to place reliance on provisional values of the contributions ahead of the 2019 Contract for Difference allocation round⁶. This means expediency is no longer required.

SHEPD proposes that the contribution would have the effect of notionally reducing the capital costs of the links, thereby reducing transmission use of system (TNUoS) charges for eligible generators on the islands⁷. The proposals should be carefully considered in light of potential consequential impacts on TNUoS charges given EU Regulation 838/2010 Part B⁸. Any potential distributional impacts between consumers and generators should be fully justified.

We note the decision to allow generators on remote islands to bid in to Pot 2 of the CfD allocation round was partially driven by the fact that those generators face significantly higher transmission costs than other onshore wind of connecting to, and using, the transmission system, due to their distance from the mainland⁹. SHEPD’s proposals, effectively, provide additional support to eligible generators on the islands. It is necessary to consider whether this additional support aligns with the Government’s policy decision relating to support for remote island wind. Potential impacts on competition in the electricity wholesale market should be considered.

SHEPD’s proposals should also be carefully considered given both network charging Significant Code Reviews.

I hope you find these comments helpful. We include answers to the consultation questions on the attached appendix. Please contact me if you would like to discuss any aspect of our response.

Yours sincerely,

George Moran
Senior Regulation Manager - Network Regulation
Centrica Regulatory Affairs, UK & Ireland

⁵ Consultation document page 4.

⁶ Consultation document pages 5-6.

⁷ Consultation document page 14.

⁸ This regulation limits average generation charges to the €0-2.50/MWh range.

⁹ Consultation document page 2.

APPENDIX – answers to consultation questions

Question 1: What are your views on the principle of DNO contributions to transmission projects generally, and contributions by SHEPD to the Shetland, Orkney and Western Isles transmission projects specifically?

In principle, a licensee should be permitted to fully fund or contribute towards another licensee's project if there is consumer benefit. The scenarios in which permitting contributions should be considered are:

- A licensee funds another licensee to deliver a project the other licensee would not have otherwise been delivered and provides network benefits in the 'funding' licensee's area.
- A licensee contributes towards another licensee's project but adaptations to the project are required to deliver network benefits in the 'funding' licensee's area.

Given the interconnectedness of the electricity system, a project delivered in a certain licence area can provide network benefits in another licence area without being specifically designed to do so. As such, we do not think it is necessary to consider contributions in a scenario in which a licensee receives exogenous benefits from a project delivered by another licensee and that project has not been adapted for the 'benefiting' licensee.

Contributing to the Orkney and Western Isles transmission projects:

Based on the information in this consultation and in the consultations on the Needs Cases for the Orkney and Western Isles links, neither of the above scenarios applies. The links have been justified based on enabling renewable output on the islands to be exported to mainland GB and it does not appear that the design of these links has been explicitly adapted to provide benefits to the distribution network. Further, SHEPD has indicated no there is no near-term, material or critical distribution need for the Western Isles or Orkney which a transmission link would meet. As such, we do not believe the need for or the appropriateness of the contributions have been sufficiently justified.

We acknowledge the possibility that reduced operating costs for on-island generation could be a by-product of the construction of the transmission links. However, it is more appropriate for reductions to be made to SHEPD's allowances for operating on-island generation if the transmission links are built, thereby ensuring consumers are not required to fund allowances no longer needed.

Contributing to the Shetland transmission project:

Again, based on the information in this consultation and in the consultation on the Needs Case, the Shetland link has been justified based on enabling renewable output on the islands to be exported to mainland GB. It does not appear that the design of the link has been explicitly adapted to provide benefits by way of losses reduction and capacity support to the distribution network on Shetland. As such, we do not believe the need for or the appropriateness of the contributions has been sufficiently justified.

We acknowledge the possibility that control support could be a by-product of the construction of the transmission link. However, it is more appropriate for reductions to be made to SHEPD's allowances, in its role as Distribution System Operator on Shetland, if the transmission link is built, thereby ensuring consumers are not required to fund allowances no longer needed.

Question 2: What are your views on the robustness of the methodology to determine the need for and value of the contribution?

- Do you agree with our views on the methodology proposed for Shetland and Western Isles/Orkney, as set out in Annex 2?

As explained above, based on the information available, we do not believe the need for the contributions has been sufficiently justified. The design of the transmission links does not appear to have been adapted to explicitly take account of the benefit to the distribution networks. The benefits to the distribution networks can be valued in several ways. However, the value of a contribution should be explicitly linked to the expenditure required to deliver the benefit.

A more appropriate value of the contribution would be the incremental expenditure (or a measure of average expenditure) needed to provide the benefit to the distribution network beyond the design needed solely to provide a benefit to the transmission network. As an example, SHEPD values the contribution relating to capacity support at 17.4% of the cost of the transmission link because it expects to rely on the link 17.4% of the time. We disagree. It is more appropriate for SHEPD's contribution to cover the cost of the incremental expenditure had the design of the transmission link been explicitly adapted to benefit to the distribution network.

In principle, if the design of a transmission link was adapted to explicitly take account of the benefit to distribution networks, and the contribution reflects incremental expenditure (or a measure of average expenditure), then a cap on the contribution is not needed.

Question 3: What are your views on how the methodology could be most appropriately implemented?

- Do you agree that more detail is required on the proposed implementation of the contribution in SHEPD's licence and industry codes before we can approve any proposal?
- Would it be more appropriate for the SHEPD proposals to be formally considered through standard industry code governance arrangements?

We agree that more detail is required on the proposed implementation of the contribution in SHEPD's licence and industry codes. We also agree it is more appropriate for the SHEPD proposals to be formally considered through standard industry code governance arrangements.

SHEPD proposes its contribution is funded by increasing its RAV and the contribution would reduce the TO's RAV equivalently. Further, because of the contribution, the project's cost would be notionally reduced by an equivalent amount, thereby reducing the capital costs taken into account when setting TNUoS charges. This, in turn, would reduce the enduring local TNUoS tariffs for eligible generators on the islands. We raise concerns about both elements.

In the consultation on the Needs Cases, Ofgem's minded-to position was to apply the CPM for these three transmission projects if they are approved. All other things being equal, consumers would be required to provide a different level of funding for the project if SHEPD contributes because of the differences in the financial parameters between the CPM and baseline price control arrangements. This, effectively, results in different baseline returns. The baseline return required to remunerate investors for funding expenditure of these transmission links should be based on the associated risks rather than whether it is funded via different routes. We agree different financial arrangements for SHEPD's contributions should be considered if the contributions be permitted, including the treatment of any over-/under-spend of allowances and the appropriate allocation and remuneration of risk.

SHEPD considers “...for reason of simplicity and speed in the tight timescales, that a change of interpretation of the [Connection and Use of System Code] CUSC methodology for calculating local circuit charges would be sufficient...”. We disagree. It is not appropriate to adopt a different interpretation without the CUSC being amended, or to adopt a different interpretation just because of expediency. Open governance arrangements apply to the CUSC and there is an established process for proposing and implementing changes. It is necessary to demonstrate that any proposed change to the CUSC better meets the relevant objectives. Further, a change proposal can be progressed via an accelerated timetable if meets the relevant criteria. Due process should be adhered to. In any event, Ofgem explains why it may be neither appropriate nor necessary to place reliance on provisional values of the contributions ahead of the 2019 CfD allocation round¹⁰. This means expediency is no longer required.

SHEPD proposes that the contribution would have the effect of notionally reducing the capital costs of the links, thereby reducing transmission use of system (TNUoS) charges for eligible generators on the islands¹¹. The proposals should be carefully considered in light of potential consequential impacts on TNUoS charges given EU Regulation 838/2010 Part B. Any potential distributional impacts between consumers and generators should be fully justified. SHEPD's proposals should also be carefully considered given both network charging Significant Code Reviews.

Question 4: What are your views on timing for confirming the contribution?

- Are there other areas of uncertainty within the proposals or wider frameworks that we have not considered and which would impact the effectiveness of the SHEPD proposals?

It is not appropriate to confirm the contribution, even on a provisional basis, ahead of the 2019 Contract for Difference allocation round without conducting a full assessment of the consumer benefits of permitting contributions and of the necessary enabling arrangements.

¹⁰ Consultation document pages 5-6.

¹¹ Consultation document page 14.

**Question 5: What are your views on any wider implications that should be considered?
- How can any wider implications best be managed?**

SHEPD's proposal in relation to the Shetland transmission link reflects the value of control support the transmission link could provide to the distribution network. It is necessary to consider the circumstances in which it is appropriate for regulated assets to be used to provide system management services that could otherwise be procured from third parties. Particularly, it is necessary to consider whether the use of regulated assets to provide system management services forecloses markets for those services and whether it erodes consumer value in the long term.