Scottish and Southern Energy
Power Distribution

Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ
email: malcolm.burns@sse.com

Geoff Randall
Head of RIIO, Electricity Transmission
Ofgem
9 Millbank
London
SW1P 3GE

12 January 2016

Dear Geoff,

Consultation on a potential RIIO-T1 and GD1 mid-period review

Scottish Hydro Electric Transmission plc (SHE Transmission) welcomes the opportunity to respond to the above consultation. We welcome Ofgem's view that a mid period review (MPR) should not be used to address performance issues or result in two four year price control periods. We do not believe that changes to outputs are required due to changes in government policy; nor do we believe that new outputs are necessary to meet the needs of consumers or other network users. Whilst there are currently a few ongoing areas of development with the outputs and incentives of RIIO-T1 e.g. Network Output Measures (NOMs) and the stakeholder satisfaction incentive (SSI), we believe that these are being adequately dealt with through the existing industry processes and guidance documentation.

We have responded to all of the consultation questions relevant to electricity transmission in an appendix to this letter (Appendix A) and discuss a few specific areas below.

Scottish Island links

We are very strongly against the imposition of an availability incentive for the Scottish Island links. We are working very closely with Island developers to mitigate their concerns over availability of the subsea cables and are seeking to provide both the information and tools necessary to mitigate the developers' concerns around risk profiles. These include information sharing with regard to the Strategic Wider Work (SWW) submissions, long term service agreements, supplier contract performance guarantees and insurance arrangements.

Discussions with the developers are ongoing and very constructive; we believe we can meet developers' requirements without the need for a bespoke availability incentive.

Moreover, introducing an availability incentive would, we believe, fundamentally change the risk/reward of the price control package and therefore risk being seen as re-opening the price control. The issues around availability are not new and were known about and discussed at the time the price control was set. The MPR process should not be used as a mechanism to revisit that work.

Revenue Drivers

We have not, as yet, seen any material downturn in connections activity following the recent government announcements on availability of renewable subsidies. Since the DECC announcements, only two projects have terminated. These terminations have not had a direct impact on our current development plans which continue to be assessed on the need to connect contracted generation timely and efficiently. Notwithstanding this, we are aware that further projects may not come to fruition, and continue to update our 'best view' of future connection requirements within our licence area. Our optioneering process considers the optimal solution for both connecting generation and the requirements for enabling and wider reinforcement works.

The revenue driver uncertainty mechanism was designed with the expectation that some projects would be above and some below the unit cost allowance. Also, since our business plan was submitted, individual schemes have changed and we have achieved efficiencies in project delivery. We have carried out a review of connection projects based upon our 'best view' of current and future projects as provided in our July 2015 RRP submission. We provide a detailed response to Question 9 in a confidential appendix. Whilst there is a wide variance in costs v allowances across shared use and sole use, and between typical and atypical schemes, overall our current best view forecast is for the costs to be within c. 8% of the allowance. When the sharing factor is taken into account, the variance is expected to be c. 4%. We believe this is within the bounds of what was expected to be captured and is in line with efficiencies achieved elsewhere.

With regard to Strategic Wider Works, these are further assessed against boundary capability and optimal timing, against a range of generation scenarios, to ensure that investment is appropriate and built at the right time. The use of Regret Analysis in the consideration of optimal timing of investment decisions is designed to protect consumers and takes into account a range of generation scenarios, in some cases additional to the industry approved Future Energy Scenarios (FES). We believe this adequately accounts for changes in background generation and demonstrates that the optimal timing of investment is in the interests of existing and future consumers.

Network output measures

We appreciate Ofgem's recognition of the issues with the existing NOMS methodology. A joint TO/Ofgem working group has been developing the NOMs methodology since July 2014, seeking to improve it through a wide scope of works over the past 18 months including the treatment of over and under delivery and its justification. Ofgem has recently increased the scope of this project and it will now be delivered in stages, with the final stage proposed to be completed by winter 2016/17. We believe that this work should continue in order to ensure delivery of a robust and workable set of network output measures.

We have not identified any additional material areas for improvement that would need to be addressed through a MPR.

Environmental discretionary reward

We are positive about the EDR and how it is changing behaviour of the TOs. However, the scheme does suffer from a number of foundational issues that we believe, if resolved, would provide an even greater vehicle for change in this area of environmental management. These proposed changes are of an operational nature and do not need to be addressed by a MPR; an open consultation on the guidance and scoring would be sufficient for inclusion in the 2018/19 submission.

Stakeholder satisfaction incentive

In 2014/15 SHE Transmission was the top-performing TO, measured across all the transmission stakeholder incentives: we achieved the highest Key Performance Indicator (KPI) score, the highest Stakeholder Satisfaction Survey score and the joint-highest Stakeholder Engagement Reward score.

We believe that our performance in relation to these incentives is clear evidence that the incentives are driving the right behaviours. We believe that Ofgem should allow time for the recent changes to the KPI baseline to bed-in rather than adjust further through a MPR.

Strategic Wider Works

Project submissions

All transmission licensees have an obligation under the Electricity Act 1989 their licences to develop an efficient, co-ordinated and economical transmission system. As such, we believe that reference to the Act can be made in the SWW guidance document to ensure that TOs continue to submit the most economic and efficient proposal in their needs cases. There is no need for any licence changes, hence no requirement for a MPR.

Monitoring projects in construction

If Ofgem believes it needs to mitigate the risk of stranded assets due to changes in circumstances between submission of a SWW needs case and completion of construction, then this can be done through updating the SWW guidance document, supported by additional reporting; we do not believe that a licence change is required and hence no requirement for a MPR.

We understand why such mitigation may be considered necessary, and are not opposed to it in principle. However, going forward, if such a review does result in cancellation of a project under construction then it will be important to ensure that all costs incurred up to cancellation are recoverable by the TO, for example: cancellation costs, penalties, redeployment of staff etc.

We assume the same requirements would be implemented for OFTOs and CATOs.

Gas Distribution

We agree with Ofgem's assessment that there are no material issues for RIIO-GD1 which need to be addressed through a MPR.

Cross-sector issues

Late delivery/non-delivery of outputs

Apart from the example provided (Western HVDC link) we do not believe that there are any areas in electricity transmission that require clarification regarding late or non-delivery of outputs. In our view any changes to delivery of outputs is best dealt with on a case by case basis if/when they occur.

Innovation and tax

We do not consider this is an issue for a MPR. We have currently only submitted one full return for RIIO-T1 (2013/14) which has resulted in £330k of research and development qualifying expenditure for tax purposes. This has given enhanced tax relief of £99k in that year.

Summary

We welcome the opportunity to respond to Ofgem's consultation on a potential RIIO-T1 mid period review. We do not believe there are any changes to outputs required due to changes in government policy, nor new outputs necessary to meet the needs of consumers or other network users. Whilst there are currently a few ongoing areas of development with the outputs and incentives of RIIO-T1 this are being addressed within existing industry processes; we will continue to work with Ofgem and relevant stakeholders on these topics.

RIIO-T1 is working. We believe we are performing well, with robust plans in place for the remainder of the price control. We do not believe there are any material issues which require to be addressed through a mid period review. This is a critical period for the industry and we believe the focus for transmission businesses should be on delivery of their plans.

Yours sincerely,

Malcolm J. Burns

Senior Regulation Manager

Appendix A: SHE Transmission response to consultation questions

CHAPTER: One – purpose and scope of an MPR

Question 1: Do you have any views on the additional clarity we have provided on the RIIO-T1 and GD1 MPR scope?

We welcome the clarity provided on the scope of the MPR, in particular the clarity around changes to outputs driven by changes in government policy and the introduction of new outputs driven by the needs of consumers or network users. In particular, we are pleased to see Ofgem reiterating its commitment to an eight year price control and reaffirmation that changes to key financial parameters or to clawback outperformance are out of scope.

We also welcome Ofgem's commitment to consider materiality as part of its decision on whether to progress with any issues under the MPR.

Question 2: Do you consider the issues we have identified for RIIO-T1 and GD1 in this consultation fall within this scope?

Given the clarity on scope, we do not feel that any of the issues raised are either necessary, material or fall within the scope of a MPR. We expand on this in our responses to the questions raised in Chapter 2 and 5 of the consultation.

Question 3: Are there any other issues within the defined scope that we have not included when assessing the need for an MPR for RIIO-T1 and GD1?

We do not believe there are any further issues that need to be considered as part of the potential MPR for RIIO-T1.

CHAPTER: Two – electricity transmission

Question 4: Based on our current assessment there may be some issues in Electricity Transmission that could be addressed through an MPR. Do you agree with this assessment?

Given the clarity on purpose and scope provided by Ofgem, no. Whilst we do agree that there are some ongoing areas of development of outputs and incentives under RIIO-T1, this should not be unexpected. Furthermore, we believe that these can be adequately dealt with through existing industry processes, for example: consultations, industry working groups and development of guidance documentation.

Question 5: We ask for detailed views, particularly from the TOs, on how the operability of the RIIO-T1 NOMs incentive mechanism could be improved. As part of this, we would like evidence on the manner in which any potential revisions may better facilitate the delivery strategy of outputs, in line with current needs of consumers and network users, and the materiality of such change.

We appreciate Ofgem's recognition of the issues with the existing NOMS methodology and the work underway to rectify them. Until this work is completed and bedded in it is too early to assess whether further changes will be necessary for RIIO-T2.

A joint working group (Ofgem and the TOs) has been developing the NOMs methodology since July 2014 and has been improving it through a wide scope of works over the past 18 months, including the treatment of over and under delivery and its justification. This work was originally planned for delivery in December 2015. However, Ofgem has recently increased the scope of this project which will now be delivered in stages, with the final stages proposed to be completed in winter 2016/17.

We have not identified any additional material areas for improvement; hence we believe that the current work is best addressed through the existing processes rather than through a MPR.

Question 6: We are seeking views on whether the Environmental Discretionary Reward is driving the right business changes within the companies and providing the outputs that consumers and network users need.

The process of completing the Environmental Discretionary Reward (EDR) executive level statement and scorecard has provided us the facility to examine our practices of environmental management and how we take a leadership role in the transition to a low carbon economy. The exercises that we have performed over the last 3 years allowed us to build processes and projects that we believe will generate benefits both now and in the longer term.

We are positive about the EDR, how it is driving the right change within TOs and a tangible output to address the needs of consumers. However, the scheme does suffer from a few issues that we believe, if resolved, would provide an even greater vehicle for change in the area of environmental management and further emphasise the key leadership role that TOs are playing in a drive to a low carbon economy. For example, the level of points and thus significance of scoring for the 7 categories is skewed towards promoting a low carbon economy to the detriment of another key objective, the focus on environmental management as well:

> "The objective of the EDR Scheme is to encourage licensees to achieve high standards in environmental management as well as to help move the industry towards a low carbon energy system, where it can do so effectively while providing value for money to consumers".

An open consultation on the guidance and scoring, timed to allow for any changes to be included in the 2018/19 submission, would be sufficient. This is not a material issue and hence there is no need for a MPR.

Question 7: We are seeking views on whether the stakeholder incentives are driving the right behaviours to get the outputs that consumers and network users need.

We welcome Ofgem's initial view that the customer and stakeholder satisfaction surveys are providing reasonable measures of performance. Our performance in relation to the stakeholder satisfaction survey (improving year on year) is clear evidence that the incentive is driving the right behaviours.

Our Key Performance Indicators (KPIs) are aligned with our stakeholder-approved stakeholder commitments. They provide objective measures of service across a range of activities which stakeholders have told us are important. Our scores to date, 91% and 86%, reflect our commitment to delivering excellent performance on the things that are important to our stakeholders.

In the first two years of the stakeholder engagement reward incentive, we have increased our score from 5.4 to 6.0, placing us equal top in the electricity transmission 'league' with National Grid. We believe that our improving score is evidence that the incentive is driving the right behaviour.

Overall we believe that stakeholder incentives are effective and driving the right behaviours. We believe that Ofgem should allow time for the recent changes to the KPI baseline to bed-in rather than adjust further through a MPR.

Question 8: We have set out some initial thinking on the following issues: submission quality for Strategic Wider Works projects, further guidance on monitoring needs cases for projects in construction, the potential need for an availability incentive for Scottish island links, and potential funding requirements for NGET's enhanced SO function, as well as on onshore competition roles. What are your views on these?

SWW submissions

All transmission licensees have an obligation under the Electricity Act 1989 and their licences to develop an efficient, co-ordinated and economical transmission system. As such, we believe that reference to the Act and/or the licence can be made in the SWW guidance document to ensure that TOs continue to submit the most economic and efficient proposal in their needs cases. There is no need for any licence changes, hence no requirement for a MPR.

Monitoring the needs case for projects in construction

The current approach to needs cases and the associated cost benefit analysis (CBA) methodology tests the proposed investment against a range of generation scenarios and considers the option of least regret. The generation scenarios are generally based on the FES and additional local scenarios can be further assessed to stress test the proposal. This was the case on our Caithness Moray needs case, where a "reduced deployment" scenario was introduced to stress test the case against a lower generation outlook. This process should mitigate the risk of asset stranding or over investment.

However, if Ofgem believes it needs to further mitigate the risk of stranded assets due to changes in circumstances between submission of a SWW needs case and completion of construction, then this can be done through updating the SWW guidance document, supported by additional reporting; we do not believe that a licence change is required, hence no requirement for a MPR.

We understand why such mitigation may be considered necessary, and are not opposed to it in principle. However, going forward, if such a review does result in cancellation of a project under construction then it will be important to ensure that all costs incurred up to cancellation are recoverable by the TO, for example: cancellation costs, penalties, redeployment of staff etc.

We assume the same requirements would be implemented for OFTOs and CATOs.

Availability incentive for the Scottish Islands

We are very strongly against the imposition of an availability incentive for the Scottish Island links. SHE Transmission's business model for RIIO-T1 reflects the Allowed Revenue as agreed under the price control settlement. This includes a number of revenue incentives, for example: Performance (offers of timely connection) or Stakeholder Satisfaction Output. Any additional incentive or output could affect the overall price control settlement and therefore risk being seen as re-opening the price control. The issues around availability are not new and were known about and discussed at the time the price control was set. The MPR process should not be used as a mechanism to revisit that work.

The suggestion of an availability incentive for the Scottish Islands needs very careful consideration so as to avoid any unintended consequences that might arise. In addition, any such mechanism adopted for the Scottish Islands could raise discrimination issues for other single circuit connections onshore where, in deploying the principles of connect and manage, customer choice has accepted non-firm connections at higher risk and therefore these may wish to be treated on an equitable basis for any incentive/penalty mechanism.

One of the key questions that must be considered, from an availability and affordability perspective, is the tension between a adopting a single circuit solution versus a double circuit: developers may want double, but can't necessarily afford the associated transmission network use of system charge. When faced with this dilemma the option of choice is single circuit despite the risk of a protracted outage (albeit a low probability event). Opting for a double circuit may render the works unaffordable (and less attractive) despite the increased availability. Proposed single circuit connections for the Scottish Islands are a customer choice, due to the high capital cost and TNUoS charges associated with double circuit subsea cable links.

Notwithstanding the above, we are working very closely with Island developers to mitigate their concerns over availability of the subsea cables and are seeking to provide both the information and tools necessary to mitigate the developers' concerns around risk profiles. These include information sharing with regard to the Strategic Wider Work (SWW) submissions, long term service agreements, supplier contract performance guarantees and insurance arrangements.

Discussions with the developers are ongoing and very constructive; we believe we can meet developers' requirements without the need for a bespoke availability incentive which, as noted above, we are very strongly opposed to.

ITPR enhanced SO Role

In assessing the current and enduring resource requirement for the Network Options Assessment (NOA), we believe there is a significant and enduring study requirement to calculate seasonal operational Boundary limits for multiple reinforcement option on their own for each of four Boundaries (B0, B1, B2, B4) in our licence area. Potentially going forward we may also need to consider combinations of reinforcement options to be assessed for the CBA to work. We expect to continue to provide design solutions and to support the SO in its modelling preparation and analysis, and interaction with the CBA results.

We also expect there to be an ongoing requirement for our Development and Project teams to support the NOA process with cost profiles, designs and environmental commentaries. Any consideration of the enhanced role will therefore have to take into account additional burdens on the TO in support of the delivery of the NOA process.

However, we believe that this can be done outside of a MPR, as part of the NOA development, with any additional costs ring-fenced and logged up until the end of RIIO-T1. Any material additional costs can then be allowed as part of the RIIO-T1 close-out process.

Onshore Competition roles

We have recently responded to Ofgem's consultation on extending competition in electricity transmission and our comments on the roles of the SO and existing TOs are relevant here.

In our view, the process proposed for project identification and pre-tender activities for medium and longer term projects blurs the statutory obligations of the SO and existing TOs. We do not believe it is efficient to have a regime where both the SO and TO would be identifying options to address system need, including SQSS compliance, and then undertake development of those options. Given the integrated nature of the transmission system, split responsibilities between the SO and TO, along with the introduction of CATOs, will not lead to the development of an efficient, co-ordinated and economical transmission system; the lack of clarity around system design responsibilities and associated liabilities will lead to inefficiencies and duplication of work.

We are concerned that the blurring of responsibilities in this area, and the potential liabilities associated with such an uncoordinated approach with lack of accountability, will increase the risk to security of supply. This cannot be in the best interests of consumers. In our view the SO role should be to identify system need, with the existing TOs maintaining responsibility for system design in their geographic areas. As with the enhanced SO role, any material additional costs can be captured and allowed as part of the RIIO-T1 close-out process.

Question 9: We wish to understand if there has been a material change in outputs due to the changes in government policy related to renewables subsidies. We ask that the TOs provide information on which connections and wider works are being taken forward compared to the ones that the unit costs were based upon and whether any variation is within the bounds of what was expected to be captured.

See confidential Appendix B: Information on best view connections for the remainder of RIIO-T1.

Question 10: We ask that the network companies provide information on any connections and wider works that are not easily correlated to a specific funding mechanism in the licence. We also ask that evidence is provided of the materiality of such issues as part of any response.

The only area we have identified is that of providing reactive compensation on the network to protect security of supply due to the high levels of wind generation and reduction in synchronous generating plant connecting to the network. Whilst these wider works have no specific funding mechanism, we have substituted an existing baseline allowance for demand connections which is no longer being used due to termination. This was detailed in our 2014/15 RRP submission and the relevant excerpt is quoted below:

Local enabling (exit) schemes provides additional transmission infrastructure to facilitate connection of new demand customers. The baseline allowance made provision for £30m (2009/10 prices) expenditure to accommodate demand connections on Shetland. No expenditure is included in the forecast for Shetland due to termination of this scheme. An overall forecast of £9.0m (2014/15 prices) is included for the installation of Reactors across our network. This forecast is £7.6m in 2009/10 prices. This work is required to provide system voltage support on the network and was not included in our baseline budget.

Question 11: We welcome views on whether there needs to be clarification of output requirements and treatment of activities (load related projects in particular), that sit outside of the revenue drivers, where they are no longer required or have been substituted.

A number of changes to the baseline requirements have been highlighted during the RIIO-T1 period:

- Our requirement to provide a demand connection for the Shetland Demand scheme is no longer required due to termination of this scheme;
- The requirement to install additional reactors onto our network to assist in managing system stability and voltage control. As stated in our 14/15 RRP our intention is to recover these costs against the allowance for the above demand connection. (Ref Q10 above); and
- Changes in requirements for SWW preconstruction funding – our license condition already provides a mechanism for substitution of pre-construction funding and associated outputs.

We believe that these changes are not material; they have been taken forward via the existing license conditions and/or accommodated within the baseline allowance. Any clarification of output requirements can therefore be done via additional guidance and a MPR is not required.

Question 12: How material do you consider the RIIO-T2 outputs issue to be? Do you consider this is an issue that we should take forward?

There will be some revenue driver schemes that we will start in RIIO-T1, but not complete until early in RIIO-T2. We assume provisions will be made to allow the associated allowances for these schemes to be built into our RIIO-T2 baseline plan, in line with previous price review arrangements. We do not believe this is a material issue but clearer guidance in this area would be useful.

CHAPTER: Four – gas distribution

We agree with Ofgem's assessment that there are no material issues for RIIO-GD1 which need to be addressed through a MPR.

CHAPTER: Five – cross sector issues

Late delivery and non-delivery of outputs

Question 20: Do you agree that we should clarify some areas where it isn't clear how late or non-delivery will be treated? If so, which areas do you consider would benefit from such clarification?

Apart from the examples provided (Western HVDC link) we do not believe that there are any areas that require clarification regarding late or non-delivery of outputs. In our view any changes to delivery of outputs is best dealt with on a case by case basis if/when they occur.

Innovation and tax

Question 21: How material do you consider innovation tax relief has been and is likely to be for the network companies? Do you consider this is an issue that we need to pursue as part of any MPR? We request that the network companies provide estimates of the benefits accrued so far due to this tax relief as part of their responses.

> We do not consider this is an issue for a MPR. We have currently only submitted one full return for RIIO-T1 (2013/14) which has resulted in £330k of research and development qualifying expenditure for tax purposes. This has given enhanced tax relief of £99k in that year. Future years are expected to provide similar levels of enhanced tax relief; we do not consider this material.