

To all interested stakeholders

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

Summary

In May 2019 we consulted on our views on proposals by Scottish Hydro Electric Power Distribution (SHEPD), to contribute financially towards proposed electricity transmission links to Shetland, Western Isles and Orkney. SHEPD is the Distribution Network Operator (DNO), that runs the low voltage network in northern Scotland and the Scottish islands. It proposed to contribute towards the transmission links as it expects these links will lead to avoided costs on its distribution network and provide additional quantifiable benefits for its customers.

Following consideration of the points raised in responses to our consultation, this letter sets out our decisions on certain key points covered in the consultation on SHEPD's proposal. It also provides, following additional information being provided by SHEPD, an update on our further thinking on the implementation of the proposals and developments since the consultation.

In our May consultation we consulted on our views that:

1. We agreed the principle of a licensee contributing towards another licensee's project, where this is shown to benefit consumers.
2. We considered that we may be able to approve SHEPD making a contribution towards the cost of a transmission link, where this contribution justifiably reflects the value of the transmission link to demand consumers.
3. We considered that for Shetland, the methodology proposed by SHEPD calculates a contribution value that may appropriately reflect the value of the transmission link to its distribution customers. SHEPD propose that the value of the contribution would be around £250m based on its current assumptions. We also supported the principle of setting a 'cap' on the level of contribution to protect SHEPD's distribution customers.
4. We did not have enough clarity or certainty on how the SHEPD proposal could most appropriately be implemented through industry codes and licences to be able to approve the SHEPD proposal at this stage.
5. We considered that for Western Isles and Orkney, the methodology did not yet sufficiently justify why any contribution was appropriate, nor did it provide sufficient justification of the value of any contribution, should such a contribution be appropriate.

Having considered consultation responses and the additional evidence presented by SHEPD:

- a) In relation to points 1, 2 and 5 above, we confirm that our views remain the same. In terms of point 5, we have received further analysis and detail from SHEPD on how it

- proposes the contribution proposal principle and methodology can be applied to the proposed links to Orkney and Western Isles. We consider that it will be necessary to separately consult on a fuller explanation of the proposed methodology early next year.
- b) In relation to point 3, we confirm that our view remains the same and note that SHEPD has updated its estimated contribution to £251m. We also confirm that we consider SHEPD's proposed cap of £394m is appropriate.
 - c) In relation to point 4, this letter confirms that we consider that a CUSC modification will need to be progressed by SHEPD in order to implement this decision. This letter confirms that we expect modifications to both SHEPD's distribution licence and SHE-T's transmission licence to also be required.

We confirm that if we approve the Final Needs Case for the proposed Shetland transmission project, we will approve SHEPD's contribution proposal, subject to it being implemented appropriately as discussed below. We also confirm that having approved the proposal, we would set the level of the contribution following completion of our Project Assessment for the Shetland transmission project (i.e. after having determined the capital cost allowances for that project).

A summary of consultation responses, and our responses to these is provided in Annex 2 of this letter.

Introduction

Shetland

In March we consulted on our minded-to decision to conditionally approve SHE Transmission's (SHE-T) Final Needs Case for a proposed new 600MW transmission link to Shetland, on the condition that Viking Energy Windfarm (VEWF) would win a Contract for Difference (CfD) in the 2019 auction.

In parallel to our consideration of this needs case, the DNO that runs the lower voltage network on Shetland, SHEPD, submitted its proposed methodology to allow its customers to make a contribution to the funding of the transmission link. This contribution was proposed because the transmission link would allow SHEPD to avoid significant investment to address the existing need for a new solution to ensure security of supply to distribution customers on the island. SHEPD has therefore proposed that its electricity distribution customers¹ make a contribution to the cost of the proposed Shetland transmission link, which it considers would reflect the fair value of the benefit to its customers from the link securing supply on Shetland.

The proposals from SHEPD represent a deviation from the prevailing arrangements. Under the prevailing arrangements SHEPD customers would not usually pay for any proportion of the transmission link. Instead, SHEPD customers would only pay for the assets that connect the distribution system to the transmission system.² In order to protect its customers from cost overruns on the transmission network, SHEPD proposed a cap on the value of the contribution to ensure that its customers would be protected from paying more than they would otherwise pay to ensure security of supply to distribution customers on the island. SHEPD has proposed a cap of £394m, which it considers reflects the cost of a distribution link to ensure security of supply on Shetland.

The full proposals are Annex 2 published alongside this letter.

On 23 October, we published an update on our assessment of the Final Needs Case for the Shetland transmission project. This explained that the condition for approval has not been met. It therefore explained that before reaching a decision on the Final Needs Case, we

¹ All distribution customers in the SHEPD region (north of Scotland).

² As set out in Annex 2, SHEPD estimate this to be approximately £30m for Shetland.

consider it would be in the interests of consumers for Ofgem to consider any revised Final Needs Case that SHE-T may wish to submit.

Orkney

Over the last 12 months we have also separately consulted on proposed new electricity transmission links by SHE-T to Orkney and the Western Isles.

On 16 September, we published our decision to approve the proposed link to Orkney, subject to the following conditions:

For Ofgem to approve the Final Needs Case for the proposed 220MW Orkney transmission project, Ofgem must be satisfied, by no later than December 2021, that new generation projects totalling at least 135MW of generation on Orkney:

- a. have been awarded a CfD; or*
- b. are likely to go ahead despite not being awarded a CfD.*

Ofgem would expect to be satisfied that a project is likely to go ahead despite not being awarded a CfD if Ofgem is provided with the results of an independent audit carried out in a manner and fulfilling such other requirements as specified by Ofgem in relation to whether the project:

- 1) is financially viable;*
- 2) has signed a relevant grid connection agreement; and*
- 3) has been granted planning permission.*

Western Isles

On 23 October, we published an update on our assessment of the Final Needs Case for the Western Isles project. This explained that the conditions for approval had not been met following the 2019 CfD auction³. It therefore explained that before reaching a decision on the Final Needs Case, we consider it would be in the interests of consumers for Ofgem to consider any revised Final Needs Case that SHE-T may wish to submit.

SHEPD has indicated that transmission links to both Orkney and Western Isles will reduce the costs it incurs in operating and maintaining the onshore generation it uses as back up to the existing distribution links to the mainland. It has also indicated that it would allow for the replacement of this back up generation to be delayed, which could mean that this generation is ultimately not replaced when it reaches the end of its serviceable life. SHEPD argues that these avoided costs would reduce the costs incurred by SHEPD's customers, and so should be captured as a benefit for the DNO customers. SHEPD therefore proposes that its customers should make a contribution covering these costs.

Our decision on the SHEPD contribution proposals

Our May consultation reviewed the following considerations of SHEPD's proposals:

- the principle of a contribution from a DNO to a transmission project;
- the robustness of the methodology to determine the need for and value of the contribution, i.e. whether a contribution is needed and how and when the value of any contribution would be determined; and
- how the methodology could be most appropriately implemented, i.e. what licence and industry code arrangements would most robustly support implementation and consideration of wider implications that should be considered, e.g. potential to set precedent for other projects.

³ SHE Transmission's proposal was that approval of a 600MW link to the Western Isles should be conditional on 369MW of specific generation being awarded CfDs in allocation round 3. Our minded-to position was that this level of generation could lead to the approval of 450MW link to the Western Isles.

The principle of a contribution

In our May consultation we identified that we agreed with the principle of a DNO contributing towards a transmission link where it is beneficial to consumers overall. We recognised that there will be circumstances where allowing such a contribution will facilitate the delivery of a more beneficial solution, with greater benefits for consumers.

The majority of respondents were supportive of the principle. One respondent suggested that the principle of a contribution should only be considered if additional costs are incurred by a licensee on a project purely to deliver or facilitate a benefit to another network operator or consumers. One respondent suggested that such a contribution should not be allowed in circumstances such as on Shetland, where SHEPD, SHE-T and one of the generators on Shetland all fall under the ownership of the SSE group. More widely, some respondents considered the contribution amounted to an inappropriate cross-subsidy within the SSE group.

We remain in agreement with the principle of a DNO being able to contribute to a transmission link where it is beneficial to consumers overall. Limiting this principle only to transmission links that incur additional costs to deliver benefits to the DNO, as proposed by the respondent, is likely to limit the overall level of benefit that can be unlocked.

In terms of concerns around whether the contribution is considered an inappropriate cross-subsidy within the SSE group, we do not consider that the contribution would fall contrary to the separation and cross-subsidy obligations that all licensees are subject to. The value of the contribution represents the value of the benefit that SHEPD's customers will receive and has been derived from a transparent methodology. The contribution would be transparently and robustly implemented and would be subject to the formal licence change and code modification processes.

We confirm that we agree the principle of a DNO contributing towards a transmission link, where this is shown to be beneficial to consumers.

The robustness of the methodology to determine the need for and value of the contribution, i.e. whether a contribution is needed and how the value of any contribution would be determined

Shetland

SHEPD's proposal to contribute to the cost of any transmission link to Shetland is based on its identification and quantification of the likely benefits the link would have for its customers on Shetland. SHEPD has broken these benefits down into three groupings:

- 1. Capacity Support:** Once Lerwick Power Station is decommissioned, demand supplies on the island would need to be secured through alternative means. Based on its analysis SHEPD expects that, if SHE-T's proposed 600MW cable link is approved, for 17.4% of the time, supply on the island would need to be directly supported by imports via the transmission link. It has therefore calculated that the value of this benefit should be quantified at 17.4% of the final value of the link. The value of this benefit would therefore be determined by the final cost of proposed transmission link. SHE-T's cost estimates for the 600MW link are £709m, meaning that the contribution from SHEPD customers would be **£123m**. Appendix 1 provides an indicative presentation of how the value of the Capacity Support aspect would change relative to changes in the final cost of the link approved.
- 2. Control support:** Alongside network capacity, existing generation arrangements on Shetland also currently regulate system stability on the Shetland distribution system. Replacement of these with an HVDC transmission cable link will provide additional benefits to the distribution system. An HVDC converter station on the

island would allow for network stability to be managed in a more efficient way, by allowing more intermittent renewable generation to replace the traditional thermal generation currently carrying out this service. Under SHEPD's methodology the indicative value of this benefit is quantified at **£117.5m**.

- 3. Losses reduction:** The solving of the demand issue using a higher voltage transmission solution would reduce the level of electrical losses relative to a comparable distribution solution. Under SHEPD's methodology the value of this impact is quantified at **£10.2m**.

SHEPD's proposal is that the contribution is capped at £394m. This value represents its valuation of the cost of the distribution cable that formed part of the winning bid for the Shetland New Energy Solution competitive process previously run by SHEPD to secure security of supply to Shetland⁴⁵. Under SHEPD's contribution methodology for Shetland the Capacity Support element of the contribution will ultimately be dictated by the final costs of the transmission link. Without a cap to the contribution, in the unlikely case that costs escalate on the project dramatically from current estimates, it could be theoretically possible that the contribution from SHEPD customers would exceed the costs SHEPD customers would have faced if the New Energy Solution had progressed as planned. We consider that capping the contribution at the value derived from the Shetland New Energy solution competitive process will ensure that SHEPD customers do not pay more for the benefits they receive than they would have done if that solution had been progressed.

Further detail of SHEPD's methodology can be found in the Updated SHEPD DSO Recommendation published alongside this decision

In terms of the robustness of the methodology developed for Shetland, in our May consultation we set out our view that:

- we consider that the methodology calculates a contribution value that may appropriately reflect the value of the transmission link to demand consumers.
- we support the principle of setting a 'cap' on the level of contribution to protect SHEPD's distribution customers. We had not reached a view on the appropriate level of that cap.

A range of views were put forward by respondents on SHEPD's proposed methodology. Whilst a number of respondents were supportive of SHEPD's proposals, some specific queries and concerns were raised. Some respondents queried the appropriateness of implementing a contribution that covers services or approaches that could otherwise be covered by the market. One respondent disagreed with the idea that the capacity support aspect of SHEPD's contribution could change as a result of cost variations across the different potential link sizes, as the link size or value would not impact on the level of benefit received. Respondents were generally supportive of applying a cap on the SHEPD contribution, though one respondent emphasised the importance of this not being seen as a target.

Whilst we agree with the principle that market derived solutions should drive the most efficient outcome, in this case, a pre-condition of the contribution is that there is a transmission link needed. Under these circumstances, this link will be providing the service to the distribution network, whether a contribution is received from SHEPD or not. Therefore, the contribution does not impact on whether the transmission link is, or is not providing services that could otherwise be provided by the market. In terms of the appropriateness of the value of the capacity support aspect of the contribution changing as the value of the link changes, we are comfortable with the approach proposed by SHEPD.

⁴ https://www.ofgem.gov.uk/system/files/docs/2017/07/shetland_new_energy_solution_-_consultation_document.pdf This consultation references the solution, but does not breakdown the costs between the cable link and the on island generation aspects of the winning solution.

⁵ <https://www.ofgem.gov.uk/publications-and-updates/decision-shetland-new-energy-solution> As set out in this decision, the winning solution was not approved.

We consider that as an approved transmission link will deliver the capacity support benefit to distribution customers, the final efficient cost of the transmission link that is approved is directly relevant to the efficient cost of providing the capacity support benefit to SHEPD consumers. In practice, as the other two elements of the contribution are fixed values, and only 17.4% of any cost variation would flow into the contribution, the level of variation in contribution is unlikely to be material. If a transmission link of a different size to the 600MW proposed by SHE-T is approved, as part of our decision we will consider whether the 17.4% figure within the SHEPD contribution methodology remains appropriate.

With respect to our decision on Shetland:

- **We confirm that we can approve SHEPD making a contribution towards the cost of a transmission link where this contribution justifiably reflects the value of the transmission link to demand consumers.**
- **We confirm that, the methodology proposed by SHEPD calculates a contribution value that appropriately reflects the value of the transmission link to its distribution customers.**
- **We also support the principle of setting a 'cap' on the level of contribution to protect SHEPD's distribution customers, and we agree with SHEPD's proposed cap of £394m.**
- **We would approve a contribution if:**
 - **we approve the Final Needs Case for the proposed Shetland transmission project; and**
 - **the contribution proposal is implemented appropriately (see 'Implementation of the proposals' below).**
- **Subject to the above conditions being met, we would set the final contribution figure following our Project Assessment of the Shetland transmission project (i.e. our determination of capital cost allowances for the transmission project).**

Western Isles and Orkney

Alongside the information submitted to us on the methodology for setting the contribution value for Shetland, SHEPD also submitted a proposal for how this contribution approach could be adapted for the proposed transmission links to Western Isles and Orkney.

Unlike in the context of Shetland, the full range of the avoided costs on Orkney and the Western Isles relied upon future SHEPD action. This is because a decision on whether or not to decommission or recommission some of the back up generation on these islands has not yet been made, and so remains uncertain.

An accurate valuation of the likely cost saving requires a robust methodology for identifying what the operational costs associated with the generation would be in the case that a transmission link is not built. We have received detail from SHEPD of how it considers these assumed costs should be calculated, but consider that this should be consulted on fully. We consider that this consultation should also cover SHEPD's proposal for how its proposed methodology will account for the future benefits for the distribution system that are derived from a transmission link, but are uncertain at the point that transmission link is approved and associated network charges are finalised.

One respondent suggested that likely transmission charge (TNUoS) savings associated with the Shetland contribution should be shared across generators connecting to Western Isles, Orkney and Shetland, rather than just those on Shetland. We do not agree that this would be an appropriate approach as the contribution would no longer be reflective of the value derived from a transmission link by local demand consumers. It would also effectively create an interdependence between generation projects on different Scottish Isles that would increase cost uncertainty for these generators. A SHEPD contribution to generators on Western Isles and Orkney would be highly contingent on the approval of a link to Shetland, with the final level of contribution to generators on each island also dependent on which other links are approved and progress. Finally, it would also represent a significant

variation from the current approach and methodology for determining network charges for links such as those to the Scottish islands.

We consider that it will be necessary to separately consult on a fuller explanation of the proposed methodology for Western Isles and Orkney contributions early next year once we have final information and evidence from SHEPD are able to finalise our position.

How the methodology could be most appropriately implemented, i.e. what licence and industry code arrangements would most robustly support implementation

In our May consultation, we set out that we did not have enough clarity or certainty on how the SHEPD proposal could most appropriately be implemented through industry codes and licences to be able to approve the SHEPD proposal at this stage. We explained the approaches that SHEPD had been considering and sought views from respondents.

SHEPD proposes that its contribution is “netted off” the actual project costs that are captured, for the purpose of calculating generator charges, at paragraph 14.15.75 of the Connection and Use of System Code (CUSC). Its original view was that this would only require a change in interpretation of the CUSC and so a formal modification to the CUSC would not be required to implement the contribution proposals.

The majority of respondents, including the Electricity System Operator, disagreed with SHEPD and supported the transparent implementation of CUSC modifications to implement the proposals into connection charges. Several respondents felt that the transparency of the wider industry process, involving the full range of industry participants, would ensure that all the potential implications of implementing the principle of the contribution methodology can be considered fully.

Since the consultation has closed, SHEPD has, following discussion with the ESO, provided additional detail of how it proposes that the contribution should be implemented through a CUSC modification. Its proposal is that the drafting of the CUSC is amended to reflect that where there is a relevant Ofgem decision to allow for a contribution from a separate licensee, the value of this contribution would be subtracted from the actual project costs captured in paragraph 14.15.75 of the CUSC.

In the case of HVDC links, such as the one proposed to Shetland, only the actual project costs associated with the sub-sea cable, the converter stations, and the relevant proportion of project overheads would currently feed into the local TNUoS charges faced by connecting generators. Since the SHEPD contribution relates to the full cost of the link, SHEPD proposes that the value of the contribution is allocated between the project costs that are covered by local TNUoS charges and those that aren’t on a pro-rated basis via a modification of paragraph 14.15.76 of the CUSC. In practical terms, this would mean that the value of the SHEPD contribution would not fully be reflected as a reduction in the local charges faced by connecting generators, as a proportion of the reduction from the SHEPD contribution would feed into the wider TNUoS charges faced by consumers.

We recognise the benefits of pursuing the required changes through the standard industry processes. **We agree in principle that SHEPD’s proposed modification to the CUSC⁶ reflects the policy intent of this decision, but consider it important for the proposals to be considered and consulted on through the formal CUSC modification process. We therefore expect SHEPD to progress the relevant codes changes (to the CUSC and System Operator–Transmission Owner Code (STC) where appropriate) through the prescribed industry processes.**

⁶ As set out within SHEPD’s Updated Addendum (Section I) and summarised in this document

In our consultation we referenced CMP303, a proposed modification to the CUSC to address an alleged defect in the level of cost-reflectivity in local circuit charges for generators. We referenced that an alternative approach was put forward to this modification via the CUSC workgroup, and that there were some interactions between this alternative and the proposed SHEPD contribution. Since the May consultation, the proposer of this alternative approach to CMP303 has not pursued it further. The original CMP303 proposal and remaining alternatives remain with us for consideration. If approved, it is still likely that the interactions of CMP303 with any code changes related to the arrangements covered by this decision will need to be addressed. That is because that modification, if approved, could also lead to specific costs being excluded from the costs of the Shetland link that feed into local circuit charges for connecting generators in a similar way to SHEPD proposes the value of the contribution will. It will be necessary to ensure that the value of the benefits for SHEPD consumers is not being double counted in the costs excluded from the local circuit charges for generators on Shetland.

The implementation of these arrangements would also require a formalised process for the contribution to be transferred from SHEPD to SHE-T through the TO and DNO licences. We would work with the relevant parties to develop the required licence amendments, and we would aim to implement the changes, following a formal consultation process in time to allow the contribution to be made at the end of construction.

We would not expect to begin work on the licence changes until a Final Needs Case had been approved for the Shetland project.

Next steps

As set out earlier in this letter, we will consider any revised Final Needs Case submissions by SHE-T for transmission links to Shetland and Western Isles in order to assess whether any such revised submission is sufficiently well justified and represents long term value for money for existing and future consumers.

We have not yet received any revised submissions. While we will endeavour to consider any potential revised Final Needs Case submission as soon as practicable, the length of the review and decision-making process will be affected by the quality of the information and analysis we receive and the robustness of any case put forward.

If we approve a Final Needs Case for either project, we would then undertake a 'Project Assessment' process to determine the efficient capital costs for the project. Subject to implementation of changes to industry codes and licences referred to above, we would at the conclusion of the Project Assessment set the final contribution figure for Shetland. This contribution would be paid by SHEPD to SHE-T at the end of construction, and revenue allowances would be adjusted accordingly in SHE-T and SHEPD's licences.

We expect to consult on SHEPD's detailed proposed contribution methodologies for the Western Isles and Orkney projects in early 2020.

APPENDICES

1. Indicative value of contribution as a result of different potential capital costs.
2. Summary of consultation responses and our views on those.

ANNEXES – supplementary documents from SHEPD published alongside this letter

1. Updated SHEPD DSO Recommendation – publication version – December 2019
2. SHEPD Shetland DSO Recommendation – Addendum, December 2019

APPENDIX 1: Indicative value of contribution as a result of different potential capital costs

Description	Value
Size of link – MW	600 (SHE-T proposed option)
SHE-T estimate of capital costs (from 2019 Needs Case submission) £m	709
Ofgem initial view of capital costs (from 2019 consultation on Needs Case submission) £m range	368 - 395
Indicative value of Capacity support within contribution (based on SHE-T estimates of capital costs)	123
Indicative value of Capacity support within contribution (based on Ofgem initial view of capital costs)	64 - 69
Value of control Support within contribution (fixed)	118
Value of reduced Losses within contribution (fixed)	10
Indicative contribution (based on SHE-T estimates of capital costs)	251
Indicative contribution (based on Ofgem initial view of capital costs)	192 - 197

APPENDIX 2: Summary of consultation responses and our views on those

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?

Views from responses

The majority of respondents were supportive of the principle. One respondent suggested that the principle of a contribution should only be applicable where a network operator's project in development specifically incurs additional costs in order to deliver or facilitate a benefit to another network operator or consumers.

A number of responses also raised points relating to the interaction of the proposed SHEPD contribution with the CfD auction, as well as potential implications for the bidding process and outcomes. One respondent reflected that the inclusion of Remote Island Wind within Pot 2 of the CfD auction was partially driven by a recognition from BEIS of the additional connection costs that these generators would face. They therefore suggested that allowing a DNO to financially contribute a significant proportion of these additional costs should lead to a reconsideration of whether these projects should be able to bid in the auction at all.

Two respondents went further by suggesting that approving the methodology for Shetland would lead to a competitive advantage in the auction for generators on Shetland in comparison to competing generation in places like the Western Isles. One of these respondents also suggested, that since SHEPD, SHE-T, and the Viking Energy windfarm on Shetland all fall under SSE ownership, the SHEPD contribution could amount to an inappropriate cross-subsidy from the regulated SHEPD business.

Our consideration of these responses

We remain in agreement with the principle of a DNO being able to contribute to a transmission link where this is likely to deliver material and quantifiable benefits to consumers. Limiting this principle only to transmission links that incur additional costs to deliver benefits to the DNO, or by excluding cases where the relevant licensees fall under a common ownership is likely to limit the overall level of benefit that can be unlocked.

Ultimately, the design of the previous and future CfD allocation rounds is a matter for BEIS. As referenced in the May consultation, the principle of a contribution from the DNO for benefits it receives from a potential transmission link is also something that we consider should be applicable to generators on both the Western Isles and Orkney.

No generator on Shetland was successful in the CfD Allocation Round 3, and the latest available public information from generators on the Scottish Isles indicates that they are seeking to progress their projects without the need for a CfD in place.

In terms of concerns around whether the contribution is considered an inappropriate cross-subsidy within the SSE group, we do not agree. The value of the contribution represents the value of the benefit that SHEPD's customers will receive and has been derived from a transparent methodology. All licensees are subject to separation and cross-subsidy obligations. The contribution would be transparently and robustly implemented and would be subject to the formal licence change and code modification processes.

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

A range of views were put forward by respondents on SHEPD's proposed methodology. Whilst a lot of respondents were supportive of SHEPD's proposals, some specific queries and concerns were raised. Some respondents queried the appropriateness of implementing

a contribution that covers services or approaches that could otherwise be covered by the market. One respondent disagreed with the idea that the capacity support aspect of SHEPD's contribution could change as a result of the size and value of the link, as the link size and value would not impact on the level of benefit received. Respondents were generally supportive of applying a cap on the SHEPD contribution, though one respondent emphasised the importance of this not being seen as a target.

Whilst we agree with the principle that market derived solutions should drive the most efficient outcome, in this case, a pre-condition of the contribution is that there is a transmission link needed. Under these circumstances, this link will be providing the service to the distribution network, whether a contribution is received from SHEPD or not. Therefore, the contribution does not impact on whether the transmission link is, or is not providing services that could otherwise be provided by the market. In terms of the appropriateness of the value of the capacity support aspect of the contribution changing as the value of the link changes, we are comfortable with the approach proposed by SHEPD. We consider that as an approved transmission link will deliver the capacity support benefit to distribution customers, the final efficient cost of the transmission link that is approved is directly relevant to the efficient cost of providing the capacity support benefit to SHEPD consumers. In practice, as the other two elements of the contribution are fixed values, and only 17.4% of any cost variation would flow into the contribution, the level of variation in contribution is unlikely to be particularly material.

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?

Views from responses

The majority of respondents, including the ESO, indicated that implementation of the proposed contribution should be considered through the standard industry code and licence modification processes for the CUSC. The ESO also indicated that it considered that a modification to the SO-TO Code (STC) would also be required to allow the appropriate flow of information between the TO and SO. One respondent emphasised that consumers should be neutral to the determined implementation approach, and that the contribution should be transferred through the ESO, rather than via a contractual arrangement with SHE-T, in order to maximise transparency.

Our consideration of these responses

We agree that the implementation of the contribution would require a modification of the CUSC. We also agree that it appears logical that an STC change would be helpful if it enhances the transparency for stakeholders. As referenced in the main body of this letter, we agree that such changes should be considered through the standard industry processes. In terms of the arrangements around the actual payment between SHEPD and SHE-T, this process would be managed through modifications of the SHEPD and SHE-T licences. This licence change process, which will be subject to formal consultation, will ensure that the contribution can be processed in a clear and transparent manner that ensures that consumers are no worse off as a result of the way the change is implemented.

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?

Views from responses

Amongst generators there was a preference for confirming the contribution as early as possible to ensure that they have sufficient certainty with which to make bids in the CfD Allocation Round 3. Otherwise, respondents were supportive of SHEPD's proposal that the value is set, subject to the cap, at the end of construction.

Our consideration of these responses

We continue to agree with SHEPD's proposal that the value of the contribution is set at the end of the construction period. We consider that this approach ensures that SHEPD customers have sufficient protection against the cost of the link reducing from SHE-T's current estimate. In practice the TNUoS charges that generators will face for this sort of link would not be finalised until the end of construction, so we do not agree that not setting this value now will lead to financial uncertainty for generators.

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

Views from responses

Respondents referenced a number of proposed CUSC modifications that, if enacted, would interact with this decision. Several other respondents emphasised the importance of the implications of our decision for future projects, with general agreement with our view that the risk and effects would need to be considered on a case-by-case basis.

Our consideration of these responses

We recognise that there are a number of potential CUSC modifications that are linked to this decision. We would expect these links to be considered through the prescribed industry process as is standard within the CUSC modification process. In relation to future projects, we maintain our view that the risks and effects will need to be considered on a case-by-case basis.