

Our approach to Strategic Wider Works

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This document and attached schedule outlines the proposed process for submission and assessment of large transmission projects to accommodate renewables. These projects are also called Transmission Investment for Renewable Generation (TIRG), Transmission Investment Incentives (TII) and Within Period Determination (WPD). Ofgem currently terms these Strategic Wider Works (SWW) Arrangements.

This document builds upon the process we set out in our July Business Plan, which received broad stakeholder support. In this paper, we have set out more information on our proposal and addressed the issues raised by Ofgem in its Initial Assessment of our Business Plan.

Our proposal

SHETL's proposed Strategic Wider Works (SWW) arrangements are based on the existing TII arrangements which were put in place by Ofgem in 2009/10 following the Government's Transmission Access Review. We have retained the principle of using a proportionate uncertainty mechanism to ensure timely, cost-effective delivery of large system reinforcements, with the objective of realising the best value for the consumer. However, the SWW arrangements are intended to build on the existing

arrangements by addressing some of the weaknesses in the current approach. Taken together, we believe that these changes give greater transparency and protection for customers. There are 6 notable differences from the TII arrangements as outlined below.

1. Currently, there are no criteria as to which capital projects can be funded through the TII mechanism. In the SHETL SWW proposal, we have set out specific criteria for projects to fall under this arrangement. Projects (which may comprise a number of elements to deliver the output) must:
 - a. Deliver a SWW output defined in terms of an increase in transfer capacity at a boundary or across the licensee's system (or equivalent where the project does not cross a boundary);
 - b. Have a capital cost of works that will be greater than £50 million (09/10 prices); and
 - c. Exclude projects, or components of projects, already funded within the RIIO-T1 settlement or TII arrangements.

The capital cost threshold of £50 million has been determined from an assessment of historic and forecast and SHETL expenditure in order to identify the breakpoint between 'business as usual' and large project expenditure.

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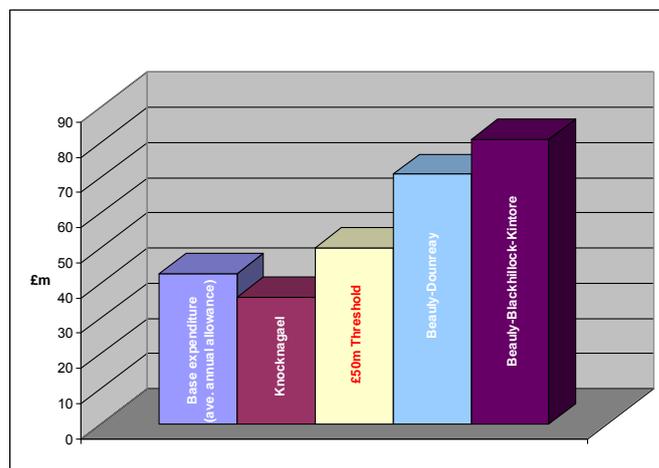


Figure 1 Base capex and TII projects up to 2011/12 (09/10 prices)

As described in our July Business Plan, we have made a distinction between our „business as usual’ expenditure (which is relatively certain) and large transmission projects (which are highly uncertain). In order to protect customers from unnecessary expenditure, and ensure system capacity can be delivered when required, the SWW Arrangements are required.

The existing TII arrangements do not have a specific capital cost criteria. Figure 1 demonstrates how historic projects might have been assessed had the new SWW arrangements been applied.

As Figure 1 illustrates, one of our current TII projects would fall below this proposed threshold and therefore, if developed in T1, SHETL would be required to fund this from its base capex allowance.

The proposed SWW arrangements would be applied to the forthcoming projects as illustrated in Figure 2¹.

As Figure 2 illustrates, all of our proposed SWW projects are above this threshold, including Beauty Mossford (as the smallest project already partially funded under TII and hence part of SWW) at £53

million. Consequently, we believe that the £50 million is an appropriate threshold for these projects.

2. The current approach only provides funding for capex incurred by the licensee with no recognition of the opex impact.
3. The current approach does include a general provision for the licensee to apply for additional costs. The SHETL SWW proposal has a detailed and specific Cost or Output Measure Adjusting Event (COTAE) provision to account for specific changes in project circumstances. The COTAE has two criteria that must be met before the licensee can apply for additional costs.

i. Materiality Threshold

The materiality of this COTAE, from a cost perspective, is >20% of the actual project expenditure relative to allowance for projects with a forecast total expenditure requirement less than £500 million and >10% of actual project expenditure for projects with a forecast total expenditure equal to or greater than £500 million and the Western Isles link. For example, for the Caithness Moray project if an allowance of £900 million is granted (as per our July Business Plan forecast) then the materiality test would be passed if actual expenditure exceeded £990 million. This threshold has been set following detailed financial

¹ Base Expenditure excludes Generation-Driven Infrastructure

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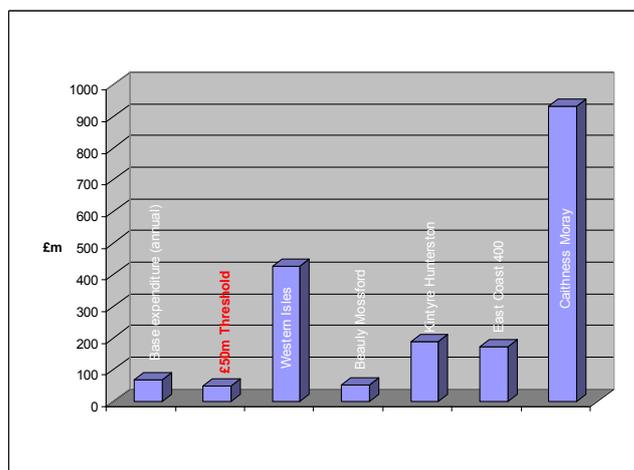


Figure 2 Base capex and SWW projects indicative example - data from July Business Plan (09/10 prices)

modelling of the cashflow impact of efficient overspend scenarios. The 10% actual expenditure materiality test has been determined as part of a broader financial package, and apportionment of risk.

ii. Valid Criteria

The change in expenditure must be due to one or more of the following criteria:

- Extreme weather (worse than 1 in 10 for land-based activity, equivalent provisions for marine-based activity); and/or
- Additional consent conditions or operational constraints imposed by a statutory body (such as further planning consent conditions, environmental constraints, traffic management constraints, health and safety); and/or
- Movement of agreed outages by the system operator that impact on project cost and/or delivery (including removal or movement of outages); and/or
- Movement in scope for reasons which could not reasonably have been known at the point of the two part assessment process (such as ground conditions, archaeology, protected flora and fauna discovered)

and must be efficiently incurred, with all reasonable actions being taken by the licensee to mitigate the effects.

The Extreme Weather criteria has been developed in line with best-practice contracting and procurement arrangements. In most NEC-based contracts, which are the industry standard and are used extensively by SHETL, there are weather provisions with a 1 in 10 threshold. If SHETL are unable to mitigate extreme weather events through the contracting and procurement strategy, we are effectively fully exposed to the cost and delivery impact of such an event. For extreme weather events associated with marine projects, we expect similar criteria to be used and will provide further information on what the baseline assumptions are following procurement and contract negotiations for these projects.

We expect to use equivalent provisions for the other criteria, adopting recognised standards to set out the baseline assumptions as part of the assessment process.

4. In the SHETL SWW proposal, there are new and specific stakeholder communication requirements regarding, not just the “normal” consenting and construction specific communications which will continue to take place, but relating to the overall project timeline and progress. The funding approval process is a key concern for some of our stakeholders and we therefore intend to continue to provide

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	2012/13	2013/14	2014/15	2015/16
Sharing factor	25%	50%	50%	50%
Allowance	100	100	-	-
Actual	90	110	-	-
Adjustment per licence			-7.5	5
Adjustment required			-7.5	7.5

Table 1 Illustrative of potential phasing of projects within years

updates in relation to progress on funding applications.

5. The current mechanism does not explicitly incentivise delivery of output measures. The SHETL SWW proposal includes defined penalties for under delivery of output measures. If, within 6 months of project completion, Ofgem notify SHETL that the output measures have not been met, Ofgem and SHETL will agree (within 3 months of Ofgem's notification) a timeline for an efficiency assessment of the impact and a pre-defined penalty will be levied accordingly.

It is critical that SHETL understand the specific penalties which may be applied for under delivery of output measures at an early point in the project lifecycle, preferably at the time of initial funding approval, to enable appropriate mitigatory actions to be taken and to allow customers sight of these penalties. Further discussion with Ofgem is required around the specifics of these penalties including the level of a penalty cap.

6. The totex incentive will be applied to the aggregate totex position of SWW projects and base capex on an annual basis (with a 2 year lag). The sharing factor we have proposed for this incentive is 50%, which has increased from the current 25% sharing factor. As the

revenue adjustment will take place on a 2 year lag, it is important that the appropriate sharing factor is applied and SHETL are revenue neutral to any phasing of this adjustment. Table 1 illustrates an example of this, where £10 million is phased from 12/13 to 13/14.

The sharing factor applied to 2012/13 under-spend would be 25%, even though it is applied in 2014/15. The corresponding over-spend in 2013/14 accounts for a recovery of the project expenditure and would be adjusted in 2015/16. However, if the "new" sharing factor is applied, the project receives a shortfall of revenue. This should be taken into account over the transition period, and SHETL must remain revenue neutral to these cross-period changes.

The following pages set out our suggested approach in more detail, giving indicative timeframes for the stages and the steps that we suggest are required.



Schedule of RIIO-T1 Strategic Wider Works Arrangements

BEFORE ASSESSMENT BEGINS (circa 3 months)

Clear qualification criteria for SWW projects, whereby all of the following apply:

- Project elements or components must be inter-related to deliver a SWW Output; and
- In the main, projects will deliver a SWW Output defined in terms of an increase in transfer capacity across a defined transmission system boundary (as per SQSS criteria). It should be noted that not all large reinforcements cross defined transmission system boundaries, e.g. the large radial Island links such as Western Isles, Orkney, Shetland. In these cases the Output measure will be the capacity of the radial link itself. In other projects the reinforcement can cross multiple boundaries, e.g. Beaulieu-Denny, East Coast 400kV. In these cases the Output measure will be an increase in transfer capacity across several transmission system boundaries; and
- Capital cost of works for a given project will be greater than £50 million (2009/10 prices); and
- Excludes projects, or components of projects, already funded within the RIIO-T1 settlement or TII.

Cost allowance is on a 'totex' basis (sum of capital and operating costs over RIIO-T1), and the financial assumptions (e.g. cost of capital, depreciation, capitalisation rate and sharing factor) are the same as RIIO-T1 settlement

Notification period of intent to begin assessment:

- SHETL to report (every 6 months) on project timelines, specifically highlighting status of project drivers and expected assessment start dates.
- SHETL provide written confirmation of intent to begin assessment ("notification date"). The notification date must be at least 3 months prior to commencement of actual assessment period.

Within 3 months of the notification date, Ofgem confirm project meets qualification criteria.

Within 3 months of the notification date, agreement (in principle) of timeline between Ofgem and SHETL (if appropriate in consultation with affected users) including key submission and decision dates for each part of the assessment in line with standard template, noting:

- Ofgem and SHETL retain scope to amend timeline from the standard template on project specific basis e.g. if needs case unusual, specific resource constraints occur, etc.
- Timeline is only agreed in principle and might be subject to change, e.g. if more detailed work required, resource constraints are encountered etc.

By notification date, stakeholder notification of project and assessment timeline:

- Following timeline agreement (in principle) between SHETL and Ofgem, stakeholder update to be published by SHETL.

Outcome: project qualification agreed and assessment timeline published



Schedule of RIIO-T1 Strategic Wider Works Arrangements

ASSESSMENT PERIOD (circa 9 months)

Two-part assessment process:

- (i) needs case, and (ii) technical (including costs and outputs)

Needs case assessment to focus on -

- High level project scope
- Timing of delivery
- Environment, security benefits
- Value for money
- “Least regrets” analysis (where appropriate for projects that have an anticipatory element of sizing project for future needs)

Technical assessment to focus on –

- Detailed project scope
- Project execution plan
- Detailed cost estimates including risk mitigation costs
- Project outputs, including impact on wider RIIO primary outputs and secondary deliverables

Both project assessments may run in parallel where appropriate.

For both parts, clear submission requirements and assessment criteria (e.g. SQSS, strategic investment, user commitment).

Generic template to be implemented including information above and the following:

- Environmental benefits
- Security benefits
- Boundary capability
- “Least regrets” analysis
- Impact on and interaction with baseline capex and opex
- Impact on and interaction with baseline outputs
- Opex requirements for remainder of RIIO-T1 period

Where possible, use of joint consultants under standardised Terms of Reference, noting that Ofgem might need to seek separate consultant advice e.g. when project is considered along with consideration of a number of other non-SHETL projects

Both parties appoint project management for Q&A, consultants, meetings, etc.

- All submissions to be appropriately reviewed, approved and monitored within SHETL (SHETL Governance Processes)
- Clear document control responsibilities
- Clear lines of communication
- Regular and scheduled communication between Ofgem and SHETL
- Ongoing, informal communication between Ofgem and SHETL encouraged

Licence condition agreed at RIIO-T1 settlement on totex basis; schedule modified for project-specific costs and outputs as determined by the Authority.

Outcome: licence modification for annual totex cost allowance, and SWW Output measures



Schedule of RIIO-T1 Strategic Wider Works Arrangements

DURING CONSTRUCTION

SHETL required to submit annual reports (costs audited with accounts) as part of RRP during construction period and Ofgem responds as part of RRP process:

- SHETL reports progress to stakeholders
- Ofgem incorporates into annual transmission report

Cost or output adjusting event (COTAE) provision in licence for prescribed circumstances. COTAE triggered by meeting both the materiality provision and the event provision.

1. Materiality provision

- Materiality of COTAE event
- >10% of total projected efficiently incurred project costs (where forecast projects costs are \geq £500 million or for the Western Isles project);
- >20% of total projected efficiently incurred project costs (where forecast projects costs are $<$ £500 million, excl Western Isles project); and/or
- where projected delivery date falls outwith the agreed financial year

2. Event provision

- Extreme weather (worse than 1 in 10 for land-based activity, equivalent provisions for marine-based activity); and/or
- Additional consent conditions or operational constraints imposed by statutory body (such as further planning consent conditions, environmental constraints, traffic management constraints, health and safety); and/or
- Movement of agreed outages by the system operator that impact on project cost/delivery – includes either removal or movement of outages; and/or
- Movement in scope for reasons which could not reasonably have been known at the point of two part assessment process (such as ground conditions, archaeology, protected flora and fauna discovered)

SHETL must also demonstrate that it has taken reasonable steps to mitigate the impact both before and after the event, taking into account customer impact and the penalty regime for non-delivery of outputs.

Baseline assumptions for all event provisions to be included in technical case submission (above).

Process, information requirements and timeline follows notification and assessment process described above.

Any COTAE will adjust revenue with a one year lag of when it is determined by the Authority.

On a totex basis, rather a project specific basis, SWW revenue will be adjusted annually with a two-year lag through the totex incentive.

Outcome: All parties able to monitor progress; amendments made (if required and criteria met); totex incentive applied.



Schedule of RIIO-T1 Strategic Wider Works Arrangements

AFTER CONSTRUCTION

SHETL notify Ofgem and stakeholders of delivery of output measures, and submit technical completion report.

Within prescribed period (SHETL preference: 6 months), Ofgem confirm output measures have been met (actual expenditure deemed efficient, i.e. no ex-post efficiency assessment required); totex incentive continues to 'true-up' revenue and RAV based on actual expenditure.

If within prescribed period (6 months), Ofgem advise output measures have not been met, Ofgem and SHETL to agree timeline for efficiency assessment within 3 month period, including key submission and decision dates.

Licence or accompanying Regulatory Instructions and Guidance set out criteria, process, information requirements and approach to assessing and directing impact of full or partial non-delivery of outputs:

- Clear criteria for determining penalty arrangements based on –
 - Whether non-delivery of output measures was outwith SHETL's control
 - What customer detriment has been suffered
 - Extent of mitigation undertaken by SHETL
 - Actual expenditure and totex incentive reward/penalty
 - Calculation of penalty for non-delivery
 - Cap on maximum penalty (% of overall project costs)
- Assessment to take into account information which could reasonably have been known by SHETL at point of two part assessment process and the overall out-turn at delivery date (e.g. if generators were expected to connect at a certain date which drives the project delivery date but the generators out-turn is late, this should be taken into account in assessing customer detriment and ultimately SHETL's penalty)

Outcome: Output measures delivered and RAV true-up through totex incentive or clear process if output measures not delivered

