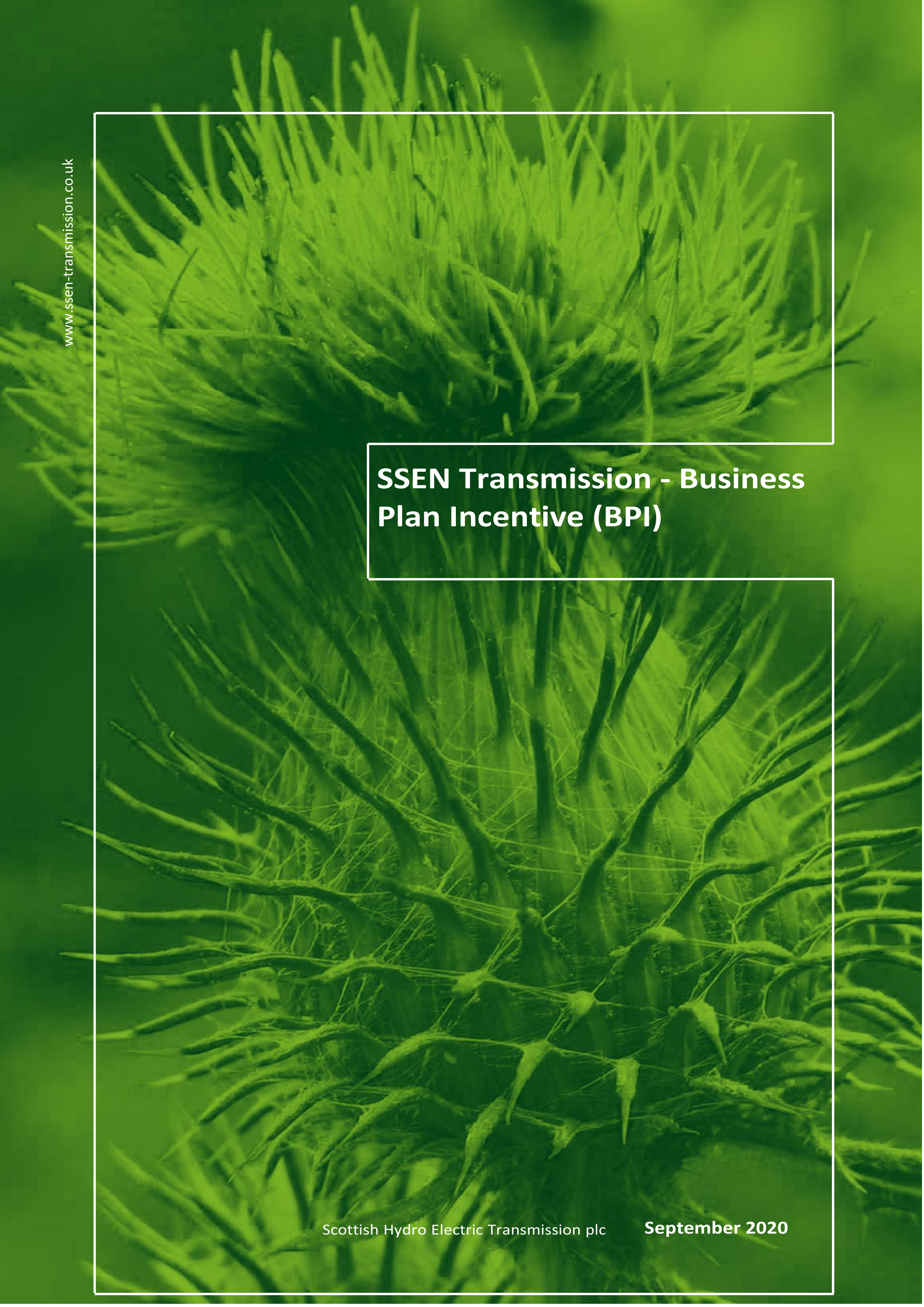

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SSEN Transmission - Business Plan Incentive (BPI)

Scottish Hydro Electric Transmission plc

September 2020

1 Introduction

This short paper sets out each individual load and non-load project that has been subject to a penalty through the Business Plan Incentive (BPI) and details our justification for why the penalty should be removed for each. The associated Excel spreadsheet ("T2BP-DD-SHE-018 Business Plan Incentive Summary Workbook (BPI)") provides, line by line for each project or cost area the associated penalty value, reason for the penalty (in Ofgem's view) and our rationale why the penalty should be removed. The spreadsheet also provides the name of any relevant supporting files such as Engineering Justification Papers. The detail contained in this paper is found there and so both must be read together.

We also suggest Ofgem read this together with our supporting paper on the Totex Incentive Mechanism (T2BP-DD-SHE-005 SSEN Transmission – Totex Incentive Mechanism (TIM)).

2 Penalty Breakdown

We provide a high-level summary of that line by line analysis below and our overarching justification for why the application of the penalty is not justified and should be removed for Final Determinations.

Table 1 - Penalty Breakdown

Penalty Driver	Penalty Value
Project Removal	30.4
Pre-construction	8.0
Risk Reduction	4.7
Low Confidence Tag - Asset Efficiency/Missing Data & Risk reduction	3.7
Missing Data/PAM Error	0.6
Total	**47.3**

Project Removal

Ofgem apply a penalty to non-load projects removed from our baseline. This penalty category comprises 64% (£30.4m) of the total (pre-cap) penalty Ofgem proposes to levy on SHE Transmission.

We have submitted revised Engineering Justification and Cost Efficiency Papers for those schemes and believe that Ofgem will approve these schemes. Therefore it follows that this penalty will be removed in its entirety.

Inveralmond House, 200 Dunkeld Road, Perth PH1 3AQ ssen.co.uk

In the event that Ofgem do not approve our projects, we have provided Ofgem with significant detail on each to allow Ofgem to make a well-informed decision. It is therefore not in line with the purported purpose of the BPI - to reward or penalise companies cost efficiency as these projects don't reach cost assessment (see Section 3.2.2 of our Main Response[1]) repeated below under the heading "Reasonable application of a penalty".

Pre-construction

We disagree with the removal of the baseline pre-construction funding and believe that this should be reinstated. This would therefore remove any penalty. We provide full details of this in Section 2.2 of our Main Response and in response to questions ET Q11 and ET Q12. We also provide extensive supporting evidence for the re-instatement in three additional pre-construction papers[2].

In any case, we believe pre-construction costs should be classed as a "high-confidence" and will therefore not be subject to a penalty in Stage 3 of the BPI. Recently returned tenders, rates based on recent tenders and realised actual costs are all clearly specified in Ofgem's Sector Specific Methodology Consultation and Sector Specific Methodology Decision as evidence in classifying baseline costs as high-confidence[3]. Further, as we propose an end of period symmetric true-up as well as PCDs for pre-construction this adds weight to the ability of Ofgem to deal with uncertainty, a key principle in allowing costs to be set as high-confidence[4]. Ofgem has failed to acknowledge at Draft Determinations in not only classifying pre-construction as low-confidence but in then subjecting the disallowed costs to a BPI penalty.

Risk Reduction & Contingency

There is a clear error in the consistency of Ofgem's methodology with its modelling for risk and contingency costs. We set this out in Section 2.3 of the Main Response and in our response to SHET Q6 and SHET Q7. Once corrected, Ofgem should reinstate the disallowed costs and therefore the associated BPI penalty will be removed.

Similar to pre-construction, Ofgem has also made an error in classifying risk and contingency costs as "low-confidence". They should be "high-confidence" and not subject to a BPI penalty. This is because our risk costs were based on RIIO-T1 outturn projects and Ofgem note that realised actual costs as the "strongest evidence a company could provide"[5] in classifying

[1] SHE Transmission, *Response to Ofgem RIIO-T2 Draft Determinations*, September 2020.

[2] T2BP-PAP-016 Pre-Construction Funding Paper, T2BP-PAP-017 PCF for T3 LRE Schemes and T2BP-PAP-018 PCF for T3 NLRE Schemes

[3] RIIO-2 Sector Specific Methodology Decision, paragraph 11.37 https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_core_30.5.19.pdf

[4] RIIO-2 Sector Specific Methodology Consultation page 92, paragraph 9.44 bullet 2. https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-consultation

[5] RIIO-2 Sector Specific Methodology Consultation page 93, paragraph 9.44 bullet 1. https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-consultation

baseline costs as high-confidence. Moreover, Ofgem has indeed benchmarked risk and contingency and by its own methodology these costs could not be subject to the stage three BPI penalty.

Approved Low Confidence Tag - Asset Efficiency/Missing Data & Risk reduction

First, this is where the full project value is subject to the 10% penalty when only one asset of the project is considered "low-confidence". We completely disagree with Ofgem's approach of bluntly tagging an approved project in its entirety as "low-confidence" due to only one element of the scheme being deemed "low-confidence" and thus exposing the full project - both high and low confidence costs being subject to a BPI Stage 3 penalty.

The projects are Beauly/Aigas - Deanie, Foyers, Willowdale and Peterhead within our Non-Load ask which have been approved but deemed "low-confidence". We have submitted further evidence to Ofgem, including revised EJPs, to provide further confidence in the full need/scope for projects as part of our Draft Determination response.

There are also missing data within the PAM which is creating a penalty due to the misallocation of asset or cost data and this needs to be corrected.

Missing Data/PAM errors

There are a number of asset and cost data issues within the PAM and this is causing a £0.6m penalty which should not be applied once the above issues have been resolved.

Reasonable application of a penalty

As we set out in our Main Response (section 3.2.2), we believe it is unreasonable that to apply the BPI to projects which are rejected at the need assessment stage

Within Ofgem's Business Plan Guidance, Ofgem states that "any costs deemed to be poorly justified and removed by Ofgem from the companies' forecasts through this *cost assessment process* [emphasis added] will be subject to a penalty"[6].

Those projects which are rejected at the needs assessment stage do not progress to cost assessment[7] and therefore could not been deemed inefficient or otherwise and should not be subject to the BPI penalty. The purpose of the BPI is purportedly to reward or penalise companies for "poorly justified cost forecasts"[8]. It is therefore illogical and unreasonable to

[6] https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-2_business_plans_guidance_october_2019.pdf page 46

[7] The process was explained by Ofgem as: each project (each EJP) was subject to an engineering assessment to determine if the need and scope was justified. If it was, then that project would progress to the cost assessment team to determine if the allowed costs where the cost efficiency would be determined. If it was not justified, the project would not proceed to cost assessment,

[8] https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-2_business_plans_guidance_october_2019.pdf page 46

apply the BPI to costs which are rejected at the needs assessment stage. This position is supported by the following reasons:

- **policy not articulated:** at no point during the RIIO-2 process (be that through formal consultations or other Ofgem engagement) was it articulated that costs associated with the removal of schemes based on Ofgem's view of need would be subject to a penalty under the BPI. A footnote in Ofgem's updated RIIO-2 Business Plan Guidance in 31 October 2019 (which was not subject to consultation and a month prior to submission of final plans) stated that the stage 3 penalty could also apply to costs associated with activity volumes removed from the Business Plan by Ofgem does not articulate a policy shift[9]. Also, through the bilateral engagement with the Ofgem Cost Assessment team, it was communicated that only projects that reach costs assessment would be subject to the BPI. This was also our logical assumption, i.e. removing projects in full at the engineering assessment stage means removing the baseline costs in full. Therefore, consumers are never at risk of overpaying for these (due to inefficient costs being allowed). It is all the more important that policy changes with such significant implications for licensees (this resulted in £32m penalty for SHE Transmission) be clearly articulated, justified and consulted upon.
- **contrary to Ofgem's policy objectives**: applying such a policy and penalising the full cost of those projects removed based on an engineering judgement is not promoting ambitious business plans or incentivising efficient costs. Additionally, this is completely out of step with the RIIO-2 stakeholder-led approach – it punishes licensees for listening to stakeholders and responding to their expectations. This approach from Ofgem will negatively impact on both current and future price controls.
- **not appropriate for needs assessments:** at the needs/engineering assessment stage, each load and non-load project was the subject of its own detailed EJP, providing significant detail on each project which should allow Ofgem to make a well-informed decision. It is therefore not in line with the purported purpose of the mechanism - to reward or penalise companies cost efficiency as these projects don't reach cost assessment.

Given all of the above, it is unreasonable to apply a penalty based on a difference of engineering opinion (that can be openly debated based on clear evidence). While Ofgem may take a different view from the network company, it does not follow that the company's view was unreasonable. Removal of allowances would be "penalty" enough but to overlay with a financial penalty is completely unreasonable, particularly when there are errors in the application of BPI mechanism (as noted below).