

Rt Hon Alex Salmond MSP
First Minister of Scotland

St Andrew's House, Regent Road, Edinburgh EH1 3DG
T: 0845 774 1741



Mr Alistair Buchanan
Ofgem
9 Millbank
London
SW1P 3GE

RECEIVED
20 FEB 2012

CF5698



17 February 2012

Dear Alistair

It was good to see you on 2 February in Edinburgh. As ever, I found your update on Ofgem's work and your views on the energy sector in general extremely informative.

Before I move on to the proposals in the final Project TransmiT consultation document, I must first pay tribute to the work that Ofgem has done during the last 17 months. This work has been extensive and impressive, conducted in a highly transparent and accountable manner, with a high degree of stakeholder engagement. I maintain that Project TransmiT must deliver an enduring transmission charging regime that meets the needs of generators across all of Scotland, and which facilitates the transition to a low carbon electricity generating mix, helping to meet the aims we all share of a sustainable, secure and affordable low carbon energy future.

Project TransmiT – Scottish Government Response

I welcomed the launch of Project TransmiT in September 2010, with the objective of ensuring the transmission charging regime allows a timely move to a low carbon energy sector. It has been clear to me for many years that transmission has a major role to play in the development of an energy generation mix with a high penetration of renewables, and that the transmission charging regime – so long a brake on renewable deployment, as we have seen in the Western Isles – can be an effective enabler of change. I welcome that Project TransmiT recognises the need for change.

Scotland has some of the best renewable energy resources in Europe, and its development and transmission to centres of demand is absolutely crucial for the decarbonisation of our electricity supply. I believe the rest of the UK – and, in the not so distant future, the rest of Europe – needs our energy. By launching Project TransmiT, Ofgem recognised that the current charging regime is working against the switch to a low carbon generation mix that Governments and the regulator are now working together to deliver.

Improved Investment Cost-Related pricing (iICRP)

I am disappointed that my favoured option of socialised charging has been modelled to suggest it would impose unacceptable costs on consumers and exacerbate fuel poverty. I believe a flat rate charge is straightforward, fair and effective. However, the electricity sector

is in a state of continuing uncertainty due to the UK Government's electricity market reform work, and Scotland has no wish to see this compounded by further uncertainty on transmission charging. I am therefore willing to accept that an element of price reflectivity based on location should remain embedded in the charging regime – provided the scale of the variance in the current locational charging approach is significantly compressed from the current levels which penalise generators in Scotland.

I am pleased that there are elements to Ofgem's preferred option that I can support. In particular, I support the recommendation to charge renewable generation according to output rather than capacity. During our conversation at your office on 24 May 2011, I suggested lowering the range between the maximum and minimum zonal charges to a scale of $\pm£5$ – giving a maximum variance of £10 between charging zones. I am pleased that RedPoint's modelling under the improved system shows a range of £9.

As you know, our aim in Scotland is to generate equivalent of at least 100% of gross electricity consumption from renewables by 2020 as part of a wider, balanced electricity mix, with thermal generation playing an important role though a minimum of 2.5 GW of thermal generation progressively fitted with Carbon Capture and Storage. It is important that the charging regime facilitates this balanced energy mix, enabling investment in both renewables and a suitable amount of baseload capacity. While the emerging proposals from Project TransmiT are a step in the right direction, it is paramount that final proposals must not put the brakes on investment on conventional generation sources in the same way they have held back renewables.

With this in mind, I am pleased to see the treatment of Scottish conventional generation is likely to improve, with the range between north and south falling to £16 (£18/kW to £2/kW respectively) from the current £27 (£21/kW to -£6/kW). It is also right that charges for all generation types should fall in the north and rise in the south. This is fair, given that transmission will increasingly work to bring electricity from the peripheries to centres of demand.

Treatment of HVDC

The modelling shows sharp rises for renewable and conventional charges in northern zones from 2020 due to the impact of the HVDC reinforcement projects. This concerns me, especially since the strategic case for their construction has been confirmed by the Ofgem/DECC led Electricity Networks Strategy Group. I am pleased that Ofgem is taking an open approach to HVDC reinforcements, given their extreme importance, and I would like to see the cost of their converter stations removed from the expansion factor calculation. Ofgem should also direct the CUSC panel to fully investigate better ways to treat HVDC links.

Island Charging

The consultation document does not address the prohibitively high island charges that are holding back renewables development and investment on the main Scottish island groups. I note the admission that Ofgem is 'less confident' in its approach - that iICRP will mean that the cost of island links should be paid for by developers on those islands - but the commitment to ask the industry panel to undertake further analysis on island charging is welcome. During our meeting on 2 February, you raised the possibility of island charges being offset by some other mechanism, such as a Section 185 cap, an island-specific Feed-in Tariff Contract for Difference or island ROCs.

Besides that these options have their own inherent problems and will take too long to deliver, my strong opinion is that transmission problems should have transmission solutions: as such, the high charges that are making island projects uneconomic should be addressed by Project TransmiT.

The Scottish Council for Development and Industry held a session on Project TransmiT in Inverness on 13 January, attended by Charles Gallacher, Hannah Nixon and Anthony Mungall of Ofgem, along with the island MSPs, councils, and developers. The focus of the discussion was firmly on the island charging problem, and it was evident on the day that there is consensus in Scotland on the need for fair treatment of the islands. This is an issue on which Scotland speaks with a united voice.

I have seen comparisons of the estimated annuitised costs of island and offshore generation, which I believe Highlands and Islands Enterprise will submit in response to the consultation. The figures are so compelling that they can stand on their own without comment or explanation, and in my opinion present a case for island generation that is powerful to the point of being unanswerable: 1GW of offshore wind would cost ~£6bn in subsidies; 1GW of island wind, with 50% of the 3 subsea links socialised, would cost ~£4.5bn. This is a saving to the consumer of ~£1.5bn.

Conclusion

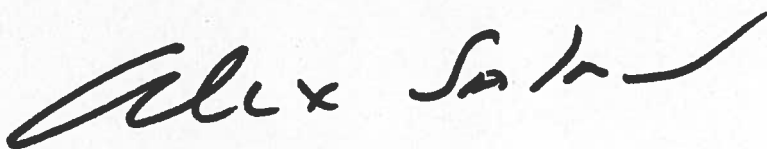
I have long argued for change in the current system, and can confirm my continued opposition to the status quo; this is not a viable option for Scottish generation, and has been holding back Scotland's renewable energy industry for many years. I fully support the proposals for the treatment of onshore generation by Ofgem's preferred iICRP model.

The problem of island charging must be addressed by Project TransmiT. I have seen the proposals that Highlands and Islands Enterprise and Scottish Renewables intend to submit to the consultation, which they consider will bring island charges down to an economically acceptable level. I note that these proposals merely entail some further modifications to the current charging regime.

I am therefore of the opinion that GEMA should direct the CUSC panel to deliver a workable solution to the island problem with the same emphasis it should on iICRP, and that the panel should complete its work in a timely fashion. 2020 is, in energy terms, just around the corner, and any further delay would be unacceptable.

I look forward to the speedy introduction of a fair transmission charging regime, and I trust that the principle of fairness will be extended to the Scottish Islands.

Yours for Scotland



ALEX SALMOND