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Dear Sirs,

Offshore Transmission Owner (OFTO) End of Tender Revenue Stream – Consultation concerning policy development

We agree it is prudent to begin policy decisions relating to end of tender revenue streams and agree the key elements of the framework are whether each generator wishes to continue beyond the end of the current revenue stream, whether it is efficient for the OFTO assets to continue in use, and whether there is a viable investment market for OFTO ownership in the extension period. This response focusses on section 3.3, which covers the tender revenue stream, and question 14 on the market value of assets at the end of the period.

Touching firstly on the proposed cost mechanism (“building blocks” or “cost plus”) we would advocate a building block approach in preference to cost plus. Cost plus would likely require a greater regulatory burden, and associated cost for consumers, which may be disproportionate in the circumstances.

Question 14 asks what market value the OFTO assets will represent at the end of the regulatory revenue period and what the component parts of that value may be. A distinction should be made between the value of the physical assets or the actual terminal value that will be realised by the owner at the end of the tender revenue stream and the terminal value that may have been assumed by bidders during the tender process.

Ofgem has referred to the equity returns implied by OFTO bids in support of arguments it has previously made with respect to the Competition Proxy Model and, more recently, as a cross check to the allowed return for the RIIO-2 price controls.

The data and calculations to support those returns is confidential and has not been made available for review but we understand that Ofgem assumes there is no terminal value. The assumption of a terminal value would increase those returns and, however uncertain that value may be, it is likely that some bidders will have factored one into their bid submissions at which point their expected returns will be higher than the values derived by Ofgem based on no terminal value.

We do not own any OFTOs and so cannot be confident of identifying a complete record of potential sources of value. It is notable that several of the potential value streams are described as complex and excluded from the scope of the current consultation, e.g. scrap value and tax losses.

We would suggest the following items could have been assumed to be a source of terminal value for an OFTO when their original bids were made:

- Scrap value and land leases – There may be some value that can be realised from the sale of any scrap from decommissioning the assets, or any remaining value in the land leases.
- Tax losses – Tax losses will carry value if they can be utilised elsewhere within a corporate group. Outstanding balances on capital allowance pools may be able to be accessed to realise further value. With appropriate planning, it may also be possible to secure tax deductions on the decommissioning costs which may not have been included in the bid model assumptions.
- Decommissioning fund – While the fund is reviewed after 8 to 9 years of OFTO operation there is clearly scope for the fund to exceed the liability at the end of the contract giving rise to an asset for the OFTO. It is also worth noting that the decommissioning fund may represent an asymmetric risk for consumers since each OFTO is a separate legal entity with limited liability.
- End of tender revenue stream – Early OFTO bidders may have had an expectation of benefitting from any extensions to the life of the assets, particularly if there has been good husbandry from the owner, given that early documentation referred to the 20-year revenue streams as being initial or a minimum.

In addition, at this stage we are not clear on whether the incumbent will benefit from additional value from being the legal owner of the OFTO assets at the end of the original revenue period. If a generator wants to continue in operation it has no choice but to connect via the OFTO assets potentially giving the incumbent owner significant bargaining power when negotiating a revenue stream or transfer value. Ofgem will need to carefully consider the property rights of the asset owner and how it can protect the interests of consumers under these circumstances.

If you have any questions on this response, then please contact Richard Allman.

Yours faithfully,

Chris Bennett

Director, UK Regulation