

Consultation on the onshore electricity transmission Early Competition commercial framework- Energy UK's response

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Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies through to new, growing suppliers, generators and service providers across energy, transport, heat and technology. Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

The sector invests £13bn annually and delivers nearly £30bn in gross value - on top of the nearly £100bn in economic activity through its supply chain and interaction with other sectors. The energy industry is key to delivering growth and plans to invest £100bn over the course of this decade in new energy sources. The energy sector supports 700,000 jobs in every corner of the country.

Energy UK plays a key role in ensuring we attract and retain a diverse workforce. In addition to our Young Energy Professionals Forum, which has over 2,000 members representing over 350 organisations, we are a founding member of TIDE, an industry-wide taskforce to tackle Inclusion and Diversity across energy.

Energy UK welcomes the proposed commercial framework for the Competition Allocated Transmission Operators (CATOs). When designing this, it's essential that network users' experience of CATOs should be equal (or ideally better) than their experience of the existing TOs. The risk that the development of the CATO process could delay the delivery of much-needed low-carbon energy projects must be mitigated. It is essential that the tendering process itself does not risk adding delays to network deployment. To be successful, the CATO framework as a whole must deliver fast, affordable and reliable connections for developers.

If you would like to discuss this response in further detail with Energy UK and its members, we would welcome further engagement.

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Consultation Response**Q1: Do you agree with NESO's proposed approach to a CATO's post-award security obligation?**

Energy UK agrees with the proposed 10% security on preliminary works. The preference to taper the security to 0% once 10% of preliminary works have been invested in by the Competitively Awarded Transmission Operator (CATO) seems right-minded. However, there is a risk of that 10% being invested, at least partly, in non-sunk costs, thus providing less risk to the CATO to incentivise them to continue development. Therefore, perhaps it makes sense for the 10% to be tapered once a certain stage of preliminary development has been achieved.

One aspect missing from this proposal is a reference to arrangements to compensate generators and storage projects that experience delays to connections as a result of CATOs. Introducing this arrangement would provide greater confidence for the CATO regime and investors in Great Britain's (GB) energy projects.

Q2: Do you agree with NESO's proposed approach to preliminary works payments?

Energy UK welcomes the National Energy System Operator (NESO) and Ofgem are looking at the use of preliminary works payments as a mechanism to lower barriers to entry for CATOs and overall agrees with the proposed approach. We believe the use of milestones, agreed between NESO and the tendered CATO would form the appropriate basis for releasing payments to CATOs and agree with the initial approach to cap preliminary payments initially. The appropriateness of milestones and caps can be revisited as NESO gains more experience in dealing with CATO preliminary works.

However, we do stress the need for early engagement between NESO, the incumbent transmission operator (TOs), the CATO and NESO to understand costs and milestones as early as possible. CATOs must be resourced and tendered sufficiently in advance to allow early engagement with the supply chain and ensure projects that are critical to the Clean Power by 2030 (CP30) plan are not delayed. It is essential too that the tendering process itself does not risk adding delays to network deployment. To be successful, the CATO framework as a whole must deliver faster, cheaper and equally reliable connections as the existing TOs.

Q3: Do you agree with NESO's proposed approach to the PPWCA process?

Energy UK appreciates that NESO has listened to market feedback and has decided to propose that revisions to revenue allowances between preliminary works and the end of construction are based on inflation being calculated separately using indexation and an upward adjustment is made during the Post Preliminary Works Cost Assessment (PPWCA) process. This appears to be appropriate as does the degree of flexibility when assigning inflation indices to individual cost buckets including the Building Cost Information Service (BCIS) and British Electrotechnical and Allied Manufacturers' Association (BEAMA) indices.

As understanding about CATO projects develops, we ask that further guidance is created for which indices are used for which cost categories, to improve and speed up the early engagement processes between NESO, TOs and CATOs. It is important these projects are delivered as quickly as possible to deliver the UK's decarbonisation objectives. There may also be much to learn from cost indexing exercises as part of the Advance Procurement Mechanism Ofgem is currently developing that can help inform indexing for CATOs'.

While we appreciate NESO's effort to align the definition of 'reasonably foreseeably' and 'reasonably unforeseeable' costs that can be adjusted with what is known by developers when CATOs are invited to tender in order to reduce debates over definitions, we do not believe that information informing cost projections arising from local stakeholder engagement and other field research should be qualified as 'reasonably unforeseeable'. NESO has suggested that engagement with authorities, local stakeholders and site visits should not be expected of CATOs prior to being awarded in order to avoid excessive "disruption to local communities".

We find this reasoning insufficient. We feel that CATOs should be expected to engage locally prior to being awarded in order to more accurately gauge costs and save time revising them at the PPWCA stage. Contrary to NESO's impression, local communities want to be involved in the development of local infrastructure this should apply to early cost investigations by CATOs. Arguments that this shouldn't be expected of them due to risks of excessive local disruption to communities, at a time when the industry should be trying to engage with communities as much as possible, is wrong-minded.

If the concern regarding excessive community disruption is truly that great, NESO should take a role in hosting ‘town hall’ style sessions involving CATO bidders with locals so as to save stakeholders time.

Energy UK agrees in principle with use of a market tested and calibrated cap on any upward adjustment in revenue CATOs are eligible for at the PPWCA stage set at 40% of the initially submitted cost estimates. However, while we understand that NESO want to take a somewhat flexible approach to adjusting this cap, especially as they learn more about the CATO process through experience, the industry would benefit from clear timelines for reviewing and adjusting aspects like the revenue adjustment cap as more knowledge about normal costs emerge over time.

Q4: Do you agree with Ofgem’s proposed adjustments to NESO’s approach?

Energy UK agrees with Ofgem’s outlined risk that if the cap on upwards cost recover adjustments at the PPWCA stage is too low, it could drive insufficient market interest in CATOs or higher bid prices. We therefore agree that NESO and Ofgem must work collaboratively to establish more defined categories of ‘reasonably foreseeable’ and ‘reasonably unforeseeable’ costs as soon as possible. As stated above, we do not believe that cost information arising from local stakeholder engagement should qualify as ‘unforeseeable’.

We also agree with Ofgem that the first tender should have a flexible cap with an incentive on bidders to build in contingency upfront. More information on what flexible cap and incentive should look like is needed. As already stated, what is also needed is a clear timeline for moving to a more defined system of setting caps as more information about CATO costs and development is gathered over time.

We also agree with a set of allowances for high impact, low probability events in the case of cost allowance uplift at the PPWCA stage. However, what range of events are permitted and the impact they have on allowances needs clear definitions.

Energy UK agrees that, in order to avoid delays and potential cost revisions, the first tender for CATOs should prioritise projects of low complexity.

Q5: Do you agree with NESO’s proposals regarding the payment mechanism and performance incentives to apply to a CATO?

Regarding incentives, it is essential to ensure that individual projects are protected commercially from CATO underperformance (delays, excessive outages, etc), and that the CATOs are suitably resourced to keep service quality up (e.g. availability for outage planning conversations, etc). The Accelerated Strategic Transmission Investment (ASTI) framework exempted network assets from competitive tendering, recognising the risk that the development of the CATO process could delay delivery. To be successful, the CATO framework as a whole must deliver faster, cheaper (or ideally both) and equally reliable connections as the existing TOs.

With that in mind, NESO's preference to have the CATO licence set out reasons for an outage that would not be considered a penalised outage appears right minded. The conditions in CATO license must be comprehensive and stringent given the importance of assuring CATOs service are as reliable as TOs.

NESO's proposed regime for service reduction revenue incentives and penalties appears appropriate.

The use of a 'seasonality factor' to incentivise CATOs to enact planned outages during periods of the year when it is likely systems constraints and demands will be low also appears appropriate. However, much more clarity is needed to assess how this factor is weighted across the year and how it would be calculated.

However, while Energy UK does agree that early delivery incentives should be targeted at CATOs essential for the Centralised Strategic Network Plan (CSNP), more clarity is needed on how NESO would calculate the consumer benefits of a CATO's early delivery and how CATO's early delivery would be assessed as critical. There should be clear, publicly available guidance for NESO on this. We disagree with Ofgem's concern that these early delivery incentives could dissuade investors bidding due to overly-ambitious timescales. If anything, it will attract investment from projects that feel they can meet the timescales. If not, then projects that successfully win the bid will simply not receive early delivery rewards.

While we appreciate the logic of NESO's recommendation not to propose a penalty for CATOs for late delivery, given they feel lost regulated revenues would provide a sufficient incentive to avoid late delivery, we urge Ofgem to consider the use of late delivery penalties, determined in appropriateness by NESO, on a case-by-case basis as NESO is already proposing to do with regards to incentives. Many future CATO's projects are essential to existing decarbonisation targets and their economics may benefit from providing penalties for late delivery and it is wrong to recommend a blanket policy that all CATOs should not be subject to penalties for late delivery.

Energy UK agrees with the need for incentives for environmental outcomes and believes linking it to Environmental Action Plans (EAPs) is essential. This incentive must be linked to the timely delivery of an EAP and on the quality of its content, especially with respect to its accessibility to a wide range of stakeholders. This detail on the incentive for this and how it is quantified needs clarifying.

The issue of SF6 gas leakage from network operators is a longstanding one and it is important that Ofgem provide a strong price signal for CATOs to limit or reduce SF6 leakage. This must be based on quantified reports and not simply on reputational incentives or action plan publications. Incentives should specifically target the use of data analytics and detection equipment for leakages. Ofgem should seek to better understand what a reasonable 'stretch-target' for SF6 leakage-reduction against a bank and its associated cost could look like for each CATO. This must account for the various costs and benefits of SF6 leakage prevention and SF6 replacement with safer gases, including emissions impacts.

We agree with the intention to penalise CATOs for non-delivery of or delays to agreed upon connection times for developers. It is important that these penalties account for current changes to the connection regime. It may therefore be appropriate for Ofgem to consider harsher penalties for CATOs for projects that are essential to achieving the Government's CP30 plan.

We also agree that it is appropriate for the CATO license to obligate CATOs to produce a stakeholder engagement report. There should be further obligations to ensure that the report is accessible and of a high quality.

We agree with NESO's proposal to not support an equity gain share for equity in a CATO in order to avoid dissuading needed investment in these projects. We believe that the need to incentivise infrastructure buildout, at this stage, outweighs any risk of excess profits from equity stakeholders selling their shares once revenues from the riskiest portion of the project is achieved. It is for this reason that getting incentives right for CATOs in order to incentivise long-term investment needs notable consideration. If this risk remains pertinent as NESO becomes more familiar with CATO's economics, the question of equity gain share can be revisited.

Q6: Do you agree with NESO's proposals regarding the additional works obligations?

Energy UK mostly agrees with NESO's preferred solution to additional works obligations and planning for such additional works. We agree that CATOs must be obligated as part of their license to accommodate connections, wider works for the TOs and adaptations from connections elsewhere in the system, even if it impacts design of the CATO during project development. Allowing a clearly structured approach to modifying works during the preliminary works stage appears right-minded and allows for an adaptive approach to changes in system need during network development.

We would stress the need for CATOs to, as far as possible, be obligated as part of their license to plan ahead of time for potentially needed adaptations to a project in order to reduce the need for adjustments to design in the preliminary works phase. This should become easier for CATOs as the Government's CP30, Strategic Spatial Energy Plan (SSEP) and CSNP emerge. We are glad to see that Ofgem agrees with this need.

Energy UK believes NESO's proposal to use a defined, yet sufficiently flexible, combination of inflation indexed unit costs based on the CATO's initial bid and using design and build tenders with third parties to manage the costs of additional works is sensible. Using the tendering of third parties maintains the competitive pressures to ensure the CATOs are cost effective, which is meant to be the benefit of CATOs in the first place. Key to ensuring the effectiveness of this will be ensuring that a flexible approach is taken to what additional works' costs can simply be based on the initial bid and which should be put out to a third party to tender. This flexibility is essential to ensuring quick decisions are made to ensure minimal delay to CATO projects should adjustments to design be needed.

With respect to the structure of the funding proposal from Ofgem, Energy UK supports the ambitious use of a hybrid model of self-financing, pass-through costs to consumers and bespoke funding arrangements agreed with Ofgem to manage the cost of additional works. This leaves room for a range of funding solutions suited to additional works in individual CATOs as well as innovative funding structures. We do share some of the concern Ofgem has. Obligating the first 20% of additional works costs relative to the initially estimated CAPEX of the project to be covered by the CATO itself, and potentially 50%, could lead to higher initial bid prices at auctions to mitigate financing risk. Ofgem must carefully monitor the impact of this mandate on the cost benefit of the competitive tenders going forward.

Nonetheless, this mixed funding structure can be adapted to be suited from one CATO to another in order to mitigate Ofgem's concerns. While we understand

Ofgem's concern about intergenerational fairness of passing through some of the costs of additional works to current customers to the benefit of future customers, we believe this to be suitable trade off and consistent with the current ethos of investing in the network now in order to lower costs for consumers in the future by enabling cheaper low carbon energy.

Q7: Do you agree with NESO's proposals regarding the revenue period and end of revenue process?

Energy UK agrees with NESO's proposed approach to the payment period for CATOs. A lifetime of 35 years and a 40-year amortisation period is mostly in line with the current financing structure for other networks while also allowing a 5-year residual asset value period to maximise the volume of interested refinancing investors towards the end of the asset's life. Nonetheless, even with this measure, unlike with TOs, CATOs may not as easily be able to secure affordable debt financing over this period compared to the far better capitalised and established TOs.

It is right, therefore, that an investigation is conducted by Ofgem into how to attract investment for this 40-year period for CATOs as part of the wider Government workstream on green financing. In line with this, Ofgem must consider a range of measures, including its proposed refinancing gain share mechanism to allow consumers to benefit from any gains made by the CATO from refinancing.

We also agree with the proposed flexible approach to dealing with payments at the end of revenue period, including an option to retender.

We agree that a Ofgem-led approach to licensing what additional CATO activities can earn revenue beyond the core business should be explored.

We also agree that NESO and Ofgem should further explore options to enable reliable asset transfer at the end of a CATO lifespan including making use of Ofgem's new powers under the Energy Act 2023 to compel asset ownership transfer.