

FAO: Jon Sharvill, Head of Onshore Competition

By email: [OnshoreCompetitionsPolicy@ofgem.gov.uk](mailto:OnshoreCompetitionsPolicy@ofgem.gov.uk)

4 December 2024

Dear Jon,

**Consultation on the onshore electricity transmission Early Competition commercial framework**

Transmission Investment (TI) is a leading independent electricity transmission business in the UK, with over ten years of experience developing, acquiring and managing large complex infrastructure projects. TI manages one of the largest offshore electricity transmission portfolios in Great Britain (GB), in total we currently manage approximately 4GW of transmission and £3billion in capital employed. TI is also leading the development of two electricity interconnector projects in support of the UK's Net Zero ambition. This includes a proposed 700MW link between Northern Ireland and Scotland known as "LirIC", as well as the "FAB" interconnector between GB and France. We are a strong advocate of introducing competition to deliver electricity transmission faster and cheaper, and we continue to support the development of the required arrangements for these competitive processes.

We welcome Ofgem's consultation on the Onshore Electricity Transmission Early Competition Commercial Framework ("the Consultation"), which seeks feedback from industry on the framework proposed by NESO, and Ofgem's views of these proposals.

It is widely accepted that successfully meeting Net Zero objectives requires substantial investment in electricity transmission infrastructure to be delivered at an unprecedented pace. Adding more organisations to deliver through early competition makes more sense than continuing to rely only on incumbent delivery, bringing in new capacity into the market to support accelerated and alternative delivery approaches.

For the competitive process to successfully deliver the best outcomes for energy consumers, it will require active building and supporting of a vibrant, transparent pipeline for the competitive market to strengthen and build commitment from existing and new supply chain partners.

We are broadly supportive of the proposals presented in the Consultation and believe that with some calibration, it will support effective market participation and enable the benefits of early competition to be realised. The design of the commercial framework, and the risk allocation between parties, will be key in delivering maximum competition for the benefit of consumers.

The first tender will be a key test for all the choices made on risk allocation and the commercial model. We believe that flexibility needs to be maintained in the framework to tailor each tender to the specific project. This will allow the risk allocation and incentives to reflect the market conditions and project characteristics such that bidders are able to price effectively (optimising risk and contingency costs), promoting participation in tenders (maximising competition), such that the overall process generates value which can be passed onto the consumer (maximising consumer benefits).

Similar to the RIIO regulatory framework, which has been refined over decades, we would expect the tender process and commercial model to continue to evolve as all parties learn from each experience. The information gathered and learning from each tender is of significant value, like any innovation, and acting on that learning will be key to ensure competition delivers the best outcomes for industry and consumers.

Our response considers the main features of the commercial framework in the order discussed in the consultation.

#### Post-Award Security Obligation

Our engagement with the market suggests that the proposal for the security at 10% of the forecast construction costs is considered high, and may limit the bidder pool, potentially increasing the cost to the consumer.

Posting securities has a cost associated with it, with providers of performance bonds, letters of credit or bank guarantees requiring substantive fees to have these facilities in place. These fees are a real cost to the CATO, which need to be financed by the investor and recovered through the Tender Revenue Stream (TRS). Therefore ensuring that any security requirements are proportionate and reasonable is integral to ensuring efficient and effective outcomes for consumers.

We recognise that the NESO and Ofgem proposal, on post-award security, seeks to ensure bidders are strongly incentivised to deliver and minimise the risk of abandonment and the delays which may result from transferring the project to another party or a CATO of last resort.

The choice of 10% of forecast construction costs appears to be seeking to align the security with the incentive exposure of the incumbent TO's under the Accelerated Strategic Transmission Investment (ASTI) scheme. While we support the principle of maintaining equity between the TO and CATO regimes the differences between the regulatory and commercial frameworks must be recognised, including:

- CATO's face strong reputational risks (a risk not faced by incumbent TOs) if they were to abandon the delivery of the project, damaging their credibility for future tenders, reducing the need for a separate financial incentive.
- CATO bear risk on bid costs, tender costs and preliminary works costs until financial close, already bearing a significant loss in the event of abandonment, reducing the need for a comparable financial security.
- The TO's are able to spread that risk across a portfolio of projects and receive rewards for early delivery, therefore across a portfolio the 10% exposure will be substantially lower and includes the potential for additional profits.
- The TO financial exposure is based on the actual delay duration up to the cap, with the cap based on incurring 3-years of delays attributed to them (and not external factors), which represents an unlikely scenario, implying that for CATO securities to be equitable it should be based on a more central assumption (reflecting consumers are exposed to the whole investment portfolio). It is notable that the average annual financial exposure for a TO for a two-year delay versus target date is 2.5% of construction costs.

We would therefore suggest it is appropriate to have a lower cap reflecting the above differences in the CATO regime compared to ASTI. Taking into account the above factors and market sentiment we would anticipate this in the low single digit percentages. We would also assume that, in line with the TO regime, the security would be the lower of the cap or 30% of constraint costs.

To reflect the increasing investment at risk by the CATO, the actual financial security amount required should also decrease through the preliminary works phase. This reflects the increasing exposure from the investments by the bidder in preliminary works (net of revenues received) treating it as security against abandonment.

In addition, we would welcome further detail on the mechanisms for how the security would function, for example, if the project was not able to progress due to factors outside of the CATO control, we would expect that the full security amount be returned to the CATO, aligned to the reliefs available to TOs in the ASTI incentive. We would also seek equity with the TO's when drawing down the security such that it would only ever reflect the actual delay incurred (assuming all parties acting reasonably to minimise the delay), with the remainder being returned to the bidder.

This would better ensure that the security is equitable, given the differences in the frameworks for TOs and CATOs, whilst remaining financeable and a material penalty for abandonment.

#### Post Preliminary Works Cost Assessment

Overall, we are supportive of the proposed Post Preliminary Works Cost Assessment (PPWCA) mechanism proposed by NESO. The mechanism is important to balance certainty for consumers with protecting bidders from unforeseen risks which cannot be managed and are therefore difficult to price.

We believe that with some further calibration, it would better enable bidders to price risk, and in turn, deliver benefits to consumers. Our comments seek to ensure there is consistency for the cost and time impacts associated with unforeseeable events and reduce the potential for dispute regarding what is considered foreseeable.

#### *Overheads and Margins*

NESO has proposed that overheads and margins will be fixed at bid (i.e. risk margin or contingency, overheads, profit margin, development costs, etc)<sup>1</sup>. We are concerned this proposal fails to recognise that if, due to unforeseeable events, the underlying costs (such as construction and/or operating costs) change, there will be an impact on the overheads and margins too.

We understand the intent is to reimburse efficient cost changes both in terms of underlying costs and applying appropriate margins and overheads, such that the CATO is held whole for changes imposed on it through the preliminary works and consenting process.

For example, increased development costs from unforeseeable events during the consenting and survey works, will increase the project management effort needed to manage the impact of scope change, and result in additional financial risk exposure from the increased scope and delivery time.

Having overheads and margins as fixed costs will result in bidders having to price the risk of increases in these costs associated with potential unforeseeable events into their contingency allowances.

Therefore further clarity would be helpful to understand how specific categories of costs will be allocated between underlying and overheads etc. This clarity will help to understand which costs will be specifically justified and adjusted during the PPWCA process and those which will be subject to percentage adjustment based on underlying cost changes. This will better maintain efficient pricing in the bid of these aspects.

#### *Time Impacts*

As above, where there is an adjustment to account for unforeseeable risks being realised during the preliminary works phase, it would be useful to clarify that the resulting impacts on timelines would be accounted for and the CATO held whole for such delay.

In NESO's engagement on the Early Competition Implementation Plan they recognised the need to have a mechanism to deal with delays, and the impacts they can cause, *"We agree that delays can have a significant impact...We would generally expect the CATO to manage the risk of delay, however the Post Preliminary Works Cost Assessment (PPWCA) may allow for adjustments to account for unforeseeable factors."* This should be explicitly included to ensure that if an event has been determined through the PPWCA as permissible, due to it being unforeseeable, then the CATO is provided with relief for all reasonable resulting time impacts, including time related costs such as prolongation. The CATO should be held whole for any knock-on delay as per the Early Competition plan April 2021 section 5.3.2, where equity returns are protected in such events.

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<sup>1</sup> Page 37 of [April 2021 - NESO Early Competition Plan, Onshore Electricity Transmission](#)

### *Reasonably Foreseeable Test and Adjustment Cap*

As currently proposed, the reasonably foreseeable test and the associated adjustment cap risks create uncertainty for bidders, and as noted by Ofgem this could lead to wide interpretations and disputes. We welcome that Ofgem is proposing to provide more detailed guidance on what would, and would not, be considered 'reasonably foreseeable' and how that could be related to the tender technical capability scoring. We would welcome consultation on this guidance to build confidence across stakeholders that it is fit for purpose.

We are supportive of Ofgem's proposals, to allow flexibility in the first tender to enable learnings to be captured and applied to future tenders, whilst ensuring appropriate measures are in place to maintain the appropriate incentives on bidders, which reflect the specific characteristics and risks of the tendered project. This may lead to different forms of reopeners, or other adjustment mechanisms, that ensure an appropriate balance of risk between the bidder and the consumer. We suggest Ofgem and NESO conducts market engagement on this during the pre-tender phase on the specifics of the first project.

We welcome the proposals to introduce flexibility in the adjustment cap for the first tender, and as the regime matures, this could be opened up to be an item to be proposed by the bidder, so that bidders' TRS can be risk-adjusted based on their level of diligence.

### *Payment Mechanism and Performance Incentives*

#### *Equity sale gain share*

We agree with NESO's proposal not to mandate an equity sale gain share, and that doing so may limit the pool of investors willing to participate in Early Competition. Different types of investors either have a preference to, or are mandated to, only invest in specific stages of the project lifecycle, and as such will have different return requirements to do so. The introduction of an equity sale gain share may dissuade a greenfield investor from selling once the project is at operations. In turn, this will result in higher capital investors staying in the project for longer (e.g. greenfield investors with a requirement to recycle capital at the start of the steady operations phase of the project) and limit lower cost of capital investors (e.g. brownfield investors that have a specific mandate to only be exposed to infrastructure with an operational risk profile) not coming into the project, which drives up the overall Equity Internal Rate of Return (EIRR) for the project as a result.

We note Ofgem's concerns that *"this proposal could, in certain circumstances, result in generating excessive profit from an equity sale during the low-risk phase as earnings required during the high-risk phase have already been secured by the investor selling its equity."*

The equity value upon sale is a function of future project cash flows and risk-adjusted returns, therefore, it is widely accepted that equity value will increase as the project is de-risked, i.e. moving from the higher risk construction period to steady state operations. Given that the required EIRR to hold the project to maturity generally reduces over the life of the project, and the risks represented by the differences between the bid EIRR (higher) and the future EIRR (lower) have either been realised (meaning the actual returns to equity could be materially lower than assumed at bid) or not. It is accepted that the equity value of the project therefore can increase once the riskier parts of the project are behind the investors. This is not a 'windfall gain' – any increase in equity value arising from an equity sale simply reflects the value earned through de-risking the project through the various stages of the development, noting there is a downside exposure for equity beyond any contingency or risk margins within the commercial framework.

The important principle to consider here is that equity returns are compensation for risk-taking. The competitive framework of the CATO tender process should drive the lowest feasible EIRR that bidders would be willing to accept for taking on the risks associated with a project. Subsequently, should an equity gain share model be introduced into the commercial framework, bidders will increase their bid EIRR relative to a 'no equity gain share' commercial framework, as they would need this compensation for the

value they may have to give up. This has the potential to limit the value that can be created for consumers through this early competition model.

#### Additional Works

We are in agreement with the proposal for limiting the windows when additional works can be requested and the principle that, acceptance of any additional works at a point in time would be assessed using a cost benefit, assessing potential to create delay in the programme.

We would note that the potential for and scope of additional works are highly uncertain and project specific. It might be preferable to calibrate the self-funding obligation percentage on a reference scope, which is a foreseeable and practical addition to the original project scope. For example, a percentage of a HVDC bootstrap may be both large and in practice unlikely to be reflective of potential additional works related to that asset.

As per the OFTO regime, the self-finance obligation should be fixed in real-terms at the time of financial close (i.e. it would reduce in real-terms over the life of the project), to allow the equity and debt providers to have a known and fixed obligation to deploy additional capital over the initial TRS period.

We would also advocate that Ofgem considers whether it would be appropriate to allow CATO to use any funding route for additional works regardless of whether it is within the remaining capacity of any self-financing obligation. This would allow the financing to be tailored to the nature of the additional works, allowing appropriate risk allocation and incentives to be set in the best interests of consumers, noting that the CATO and TOs will be similarly delivering works within the framework of the System Operator Transmission Owner Code (STC).

#### Revenue Period

##### *External debt refinancing*

We agree with NESO's position, that when the external debt requires refinancing (end of tenure) the risk should sit with consumers. This maintains the approach for the initial financing of the project and will drive competitive financing overall. Given the long-tenure of initial debt (20 or 25+ years), equity will find it challenging to price interest rates effectively and will struggle to gain access to efficient interest rate hedging that far in the future (as it's likely to be limited or not price competitive), resulting in inefficient pricing.

We recognise that there is an external debt refinancing gain-share in the OFTO regime, which reflect that the duration of the regime is aligned to normal debt tenures, and for a consistent risk profile for a proven operational asset over that period. This is a choice by the OFTO as to when, and whether, it undertakes such a refinancing based on an expectation of a gain, rather than a necessity as required for the CATO.

We hope the contents of the letter are helpful, and we would be pleased discuss any points raised.

Yours sincerely,



**Mark Fitch**  
Corporate Development Director