

Consultation on the onshore electricity transmission Early Competition commercial framework

National Grid plc response

This response to Ofgem's "Consultation on the onshore electricity transmission Early Competition commercial framework" dated 21 October 2024 (the consultation) is from National Grid plc (NG), on behalf of our transmission business, National Grid Electricity Transmission plc (NGET) and our electricity interconnector business, National Grid Ventures (NGV).

We welcome this consultation as an important step towards establishing a framework for Early Competition in Great Britain.

We continue to support genuine Early Competition, if well designed. With the right design, the framework could bring benefits to consumers by encouraging greater innovation in project design/delivery and reduce costs to consumers, as well as bringing new players/investors into the sector where investment needs are accelerating.

These benefits need to be over and above what incumbent network companies can already achieve and deliver using competitive processes for supply chain contracts, through RIIO/ASTI incentives, as well as through company-specific innovations. National Grid are already increasing focus on innovation through RIIO funded innovation projects and National Grid Partners, our corporate venture capital and innovation group, investing in innovative solutions and connecting them to our business units and ways of working. For example, supporting the deployment of Artificial Intelligence (AI) based tools to monitor asset health and to increase transmission line capacity.

For consumer benefits to be realised, it is essential that the Early Competition **framework is well designed** and that there is **time to accommodate a competitive process** without delaying delivery of key network investments.

Designing the framework to maximise consumer benefits.

Our view is that the benefits to consumers of the Early Competition regime will be maximised by designing a framework which:

- (i) brings forward **financially resilient** organisations with the **right skills and knowledge**;
- (ii) encourages **robust and well-designed projects/bids**; and
- (iii) strongly **incentivises successful bidders to innovate, deliver and perform**.

These critical success factors should be used to guide Ofgem decisions around the design of the framework to ensure a proportionate approach is taken which maximises consumer benefits.

These factors should also be considered holistically in the context of NESO's Cost Benefit Analysis (CBA) methodology. The original CBA¹ outlined significant benefits to consumers from competition when considering qualitative factors such as innovation, whereby different systems, processes and/or technology could deliver consumer value. As the Competitively Appointed Transmission Owner (CATO) Early Competition regime develops, we need to ensure that this remains the case in light of a more planned network approach, e.g. with the Centralised Strategic Network Plan (CSNP). CATOs should also be obliged to comply with the relevant industry codes and standards in developing and operating assets (such as the SQSS and Grid Code) to ensure a fully interoperable and reliable network.

For the Early Competition regime to be effective and deliver benefits to consumers it needs to encourage robust bids, incentivise delivery and promote innovation. We support Ofgem's ambition to promote robust and high-quality bids, and in particular we welcome that bids will be evaluated on quality (e.g. deliverability, consenting strategy, supply chain strategy, financing) as well as on a bidder's proposed Tender Revenue Stream (TRS). **However, we have concerns**

¹ [download \(neso.energy\)](https://www.neso.energy)

that the proposals as they stand do not set sufficiently strong incentives for robust, innovative and low-cost bids nor for efficient/timely delivery and performance.

We think there is a risk that cost of equity will be the key determining factor in selecting a successful bidder, given there is significant scope in the framework as proposed to adjust project costs, including cost of debt, coupled with the reduced scope for innovation on design (with the move towards CSNP). Competing primarily on cost of equity with reduced scope for design and delivery innovation reduces the potential benefits to consumers from Early Competition. For the Early Competition regime to provide meaningful 'price discovery' of the cost of equity for early projects with construction cost and timing risk, the framework should not overly shield winning bidders from these risks and **the final design of any Early Competition regime should encourage genuine competitive pressure and incentives on factors beyond the cost of equity.**

Ensuring that the competition encourages robust bids that reflect the risks of delivering complex onshore transmission assets is essential. **The framework should not encourage a 'bid low and negotiate up' approach** which could lead to the benefits of competition being eroded as costs increase beyond those forecast in the initial TRS bid and asset delivery is delayed.

We are aware that some new entrants to the market may have less on-the-ground delivery experience and expertise compared with existing Transmission Owners (TOs). This may inadvertently lead to lower TRS bids that do not reflect the true cost(s) and risks of the project. **How bids are assessed in terms of completeness and suitable identification of likely risks will be key to a successful framework.** We would welcome further clarity on how NESO intends to do this (for example, the definition of 'unforeseeable costs' and how 'deliverability' will be assessed).

To align with the move towards a more centrally planned network, the Early Competition model is now competing projects at a 'later' stage of development than was originally envisaged, with strategic project parameters expected to be set through CSNP. As well as having reduced the scope for innovation at this stage, bidders will also be targeting the same supply chains. In combination, we believe this could limit the likelihood of a true competition on TOTEX.

Moving from a pilot to the enduring regime

We acknowledge that the framework will need to evolve from the pilot tender and support the application of lessons learned and updating aspects (such as the CBA to include actual data). It is important to recognise that some lessons will not be learned for a considerable period of time, during which further projects could go to competitive tender. We accept that the framework will not be perfect at the stage of the first pilot project, however, to deliver the best value for consumers the Early Competition framework needs to, from the outset, provide a balanced risk profile and strong incentives for robust bids, delivery and performance (as we see in ASTI / RIIO). We are supportive of Ofgem's proposals to strengthen its approach to post implementation evaluation as set out in the recent call for input on its economic evaluation strategy. We consider that a post implementation evaluation of the pilot tender will be a valuable exercise in assessing the costs and benefits of the regime and to learn lessons to feed into future policy design.

We also note Ofgem's suggestion to focus for the first tender on a project that is not too complex from a technical and consenting perspective. On the one hand we agree that this is a sensible approach and creates a 'safe space' to test a framework. However, on the other hand, there is a risk that a simpler project underrepresents the complexity of much of the onshore network and could lead to decisions on the enduring framework that do not reflect the true risk profile for delivering the project nor provide meaningful 'price discovery' on the cost of equity. Moreover, the pilot project will represent critical infrastructure; we cannot afford for the framework to 'fail'.

Consumers must be protected in the design, while ensuring this critical national infrastructure is delivered and financially resilient.

With this in mind, our view is that:

- The **level of security** required from bidders should strike a balance between incentivising bidders to participate, whilst protecting consumers (i.e., protecting against non-delivery of the project). We think financial resilience of potential bidders is paramount given these investments are critical national infrastructure. We agree with the obligation to post a security and think that 10% security is too low to protect consumers and prevent bidders from simply walking away if costs go up.

- The process for **cost adjustments** post-bid should be limited to avoid artificially low bids which are then negotiated upwards. In particular, clarity on the definition of “unforeseeable costs” is essential to the success of the framework and to protecting consumers from price increases.
- **Preliminary works payments** should reflect all spend on relevant activities up until construction if the proposal is to achieve its intent of supporting bidders to reach financial close. We agree with the proposal to link this to milestones ensures a level of accountability and suggest that aspects to align CATOs with the Advanced Procurement Mechanism could also be included under this proposal.
- **Additional work payments** policy should be set up front and be funded mostly by the CATO, with additional costs added to the TRS. We agree with Ofgem that putting significant pass-through costs on consumers is not appropriate.
- **Performance incentives** should be more aligned with RIIO. For example, the availability incentive from the Offshore Transmission Owner (OFTO) regime is not a suitable comparator given the fundamental difference in the assets being considered (an operational asset connecting a single generator, versus an integral part of a wider network).
- The **basis for competition and weightings/adjusted TRS** should be focused on bids/bidders that can deliver at pace, have robust investment design/proposals, and which protect/benefit consumers.

The broader landscape has shifted during the development of the Early Competition framework, including the move towards a more centrally planned network and subsequently to a later model of Early Competition. The macro environment has changed significantly since the proposal to compete large scale infrastructure projects was recommended as part of the Integrated Transmission Planning and Regulation (ITPR)² project in 2015. We have seen significant constraints in the supply chain, an enhanced focus on speed of project delivery and challenges in the financial markets. **Overall, we think it is essential for Ofgem to consider whether the Early Competition framework will deliver clear benefits to consumers in the way it is designed currently and considering the changes in the wider landscape.**

As it stands, the framework does not provide sufficient incentives for robust bids or competitive pressure on design costs. To create a robust and investable framework all components of the commercial model must be considered together. Revisiting the objectives of the framework to ensure that Early Competition is not driven solely by cost of equity but encourages competition on innovation and efficiency of design is crucial. Only then will it truly serve the interests of consumers and achieve its intended benefits.

Our responses to the specific consultation questions are set out in the appendix of this document. We welcome further engagement with Ofgem to support the development of the Early Competition regime, and to achieve the best value for consumers.

² [Integrated Transmission Planning and Regulation \(ITPR\) project: final conclusions | Ofgem](#)

Appendix

Responses to the question raised in the consultation

1. Do you agree with NESO's proposed approach to a CATO's post-award security obligation?

We agree with the proposed obligation for CATOs to provide security on award of the project. We think that a 10% security is too low to protect consumers. For example, if costs during the preliminary works increase due to 'reasonably foreseeable' changes, then it is possible that these costs could outweigh the 10% security making the option to walk away the favourable one. To align with our response to the proposals on preliminary works payments, we do not agree that the security should taper down before construction has started. We support the security tapering to 0% as equivalent investments are made during the construction phase and linked to appropriate milestones. We believe that this provides a much stronger incentive for successful bidders to stay the course and deliver the asset, noting that we suggest funding all preliminary works up to a cap to help successful bidders achieve financial close.

We suggest that a letter of credit from a bank would be a suitable form of security.

As per our response to Question 3 below, the process for determining what is reasonably foreseeable or unforeseeable will be key to ensuring that initial bids are robust and account for the known risks as much as possible. Without clarity and objectivity on this complementary aspect of the framework our view is that a 10% security is too low to ensure that once a successful bidder is chosen, they are incentivised to continue with the project.

2. Do you agree with NESO's proposed approach to preliminary works payments?

At a principles level we understand the intent of this provision is to align with the allowances for pre-construction funding provided to incumbent Transmission Owners (TOs) and we welcome this proposal. The proposal will help remove barriers to entry, more appropriately share risk between the CATO and consumers and enhance the overall competitive process. However, with a cap set at 50% for preliminary works costs, and no financial support considered during the significantly more costly construction phase we are uncertain whether this mechanism will achieve its intended outcomes of supporting successful bidders to complete the delivery of the assets, where cash-flows are more likely to be important during construction.

If the proposal is to achieve its intent of supporting bidders to reach financial close, we think preliminary works payments should reflect all relevant spend up until construction in line with the support afforded to TOs during the pre-construction period, to the cap set by NESO. As the spend on preliminary works will ultimately be netted off the TRS, we believe that this is sufficient incentive to control costs during the preliminary works phase. We would welcome clarity on which activities would be considered as eligible for these payments and suggest that alignment with the activities that qualify as Pre-construction Works (as defined in Special Condition 1.1 (Interpretation and definitions) of the incumbent TOs' licences) for incumbent TOs is a sensible starting point, as well as considering other costs considered under the existing TO frameworks to support aspects such as securing supply chain capacity (noting that the recent consultation on the Advanced Procurement Mechanism would not apply to CATOs). We agree with the proposal to link these payments to milestones to ensure a level of accountability.

We consider the posting of a security and capping preliminary works payments are two mechanisms to achieve the same outcome. We believe that the posting of a security is the most appropriate mechanism to mitigate the risk of a successful bidder walking away.

3. Do you agree with NESO's proposed approach to the PPWCA process?

It is important that the CATO tender attracts a wide pool of bidders and is competitive on costs and we are therefore in favour of a mechanism that encourages robust bids. We agree that a cap on cost adjustments as part of the Post Preliminary Works Cost Assessment (PPWCA) is one way to reduce the risk of artificially low bids and helps to balance the risks borne by bidders and consumers.

A possible alternative model to consider is that of US competitive transmission where bidders include an amount of additional CAPEX costs they are willing to cover, with anything above that being shared with consumers.

Developing what can reasonably be considered 'unforeseeable' will be key to the success of this proposal. We agree that detailed guidance on how the foreseeable/unforeseeable test would be applied is essential, and we would welcome further engagement with and clarity from Ofgem to ensure that this mechanism strikes the right balance of supporting robust bids while acknowledging that some aspects will not be foreseeable from a purely desk-based approach to designing the bid.

Getting this aspect of the framework right will protect against a 'bid low and haggle' approach'. We have seen this with the outcome of the Mersey High Voltage Pathfinder project, where the winning bidder did not accurately price in a risk

on securing outages which was considered in the counterfactual case provided by National Grid, reinforcing the need for a robust and fair process that ensures that consumers are adequately protected from increases to the TRS that should be captured at the bid stage.

4. Do you agree with Ofgem's proposed adjustments to NESO's approach?

We do not agree with Ofgem's suggestion of a flexible cap on PPWCA increases. Not only does this create uncertainty for bidders but it could also support a 'bid low and haggle' approach if bidders can appeal to Ofgem where cost increases are incurred because of poor bids or poor assessment of risks at the Invitation to Tender (ITT) phase.

We agree that "foreseeableness" is subjective unless clearly defined. We would suggest that in assessing the bids received, NESO conducts a review across all bids to identify where differences in costs may be driven by the robustness of a bid (e.g. a lower TRS is driven by a bidder having followed a less robust process in developing a bid). This assessment will help the NESO to position bids, not just in terms of costs but also suitability and robustness.

We agree with the proposal in paragraph 4.31 of the consultation to exclude specific high impact, low probability events from any mechanism for cost adjustments to avoid these being priced into bids at the expense of consumers. We would welcome further detail on what kinds of events constitute those that would sit outside of any such mechanism, noting the OFTO approach for Income Adjusting Events and whether something similar is required for CATOs and how "reasonably unforeseeable" cost(s) will be assessed as "economic and efficient."

We also note in the recent publication by NESO on stakeholder feedback³ (and how this has informed the development of the Early Competition framework) the suggestion of a gain share between the CATO and consumers at the PPWCA stage. This is not a policy we have seen before, and we would welcome confirmation on whether this is intended to be applied and if so, how it would work in practice.

In the consultation, Ofgem suggests selecting a project that is not too complex from a technical and consenting perspective for the first tender. On the one hand we agree that this is a sensible approach and creates a 'safe-space' to test a framework in its infancy. However, on the other hand, there is a risk that a simpler project underrepresents the complexity of much of the onshore network and thus, could lead to decisions on the enduring framework that do not reflect the risk profile of the framework. We look forward to Ofgem's consultation on the selected pilot project to provide further transparency and rationale for recommended project(s).

5. Do you agree with NESO's proposals regarding the payment mechanism and performance incentives to apply to a CATO?

We broadly agree with the proposals outlined.

We agree that the proposed payment mechanism is appropriate for the competitive process in question, which includes the detailed design, consenting, construction and operations and maintenance of an asset.

The balance between risks and incentives is important for attracting a wide range of potential bidders whilst protecting the interests of consumers by encouraging performance. We agree with the proposal to include relevant incentives as part of the commercial framework and subsequently included in the licence. We think that these should be equivalent to obligations that already exist for incumbent TOs.

We do not agree that asset health related incentives would be too onerous for CATOs. Safe and reliable operation of the network is paramount, and we think that the CATO framework should have equivalent responsibilities compared to TOs with regards to the current and future operation of assets (including the Network Asset Risk Metric etc).

We do not agree that mirroring the availability incentive for OFTOs is appropriate for CATOs. OFTO assets have, to date, provided a connection for a single generator, with relatively limited impacts for outages. CATO assets will be integral to the operation of the network as a whole and as such, a fault or outage is likely to have a greater impact. Instead, we recommend that a similar incentive to the 'energy not supplied' incentive that applies to TOs (under RIIO) is more appropriate and better reflects the nature of the assets; this would also align with CATOs being subject to the same obligations and code requirements on maintaining reliability as TOs.

We agree that the delay of the TRS payment provides a suitable delivery incentive. Ofgem and NESO should consider whether this incentive remains proportionate and sufficiently strong where project delivery is delayed significantly beyond its anticipated in-service date, with potential impacts on the wider network and costs to consumers.

³[download](#)

The proposal for a timely connections incentive is sensible, and we agree that the revised incentive for TOs should also apply to CATOs.

We agree with NESO's position, which does not support an equity gain share mechanism. The TRS blends the returns required through the more risky construction phase and the less risky operational phase. Having a gain share mechanism allows a winning bidder to sell the asset once constructed and might encourage a wider pool of bidders, such as those that only want to build, but not maintain the asset. We think that this could be a source of benefit to consumers. To provide reassurance to TOs, any sale of assets should be governed by NESO and /or Ofgem to ensure that the new owner will be bound by the same standards as the CATO and that it is financially robust and able to take on ownership and maintenance of the assets.

6. Do you agree with NESO's proposals regarding the additional works obligations?

We agree that the framework should place obligations on CATOs regarding additional works – the assets to be delivered through this process will be integral to the successful operation of the network as a whole. The value of these assets will be maximised if they are maintained and upgraded in line with wider network needs. Importantly, this also aligns the responsibilities of CATOs with TOs under the System Operator Transmission Owner Code (STC).

We agree with the proposals to consider the viability of additional works at different stages of the process, and where additional works are likely to cause delays to delivery of the project then they should not be pursued. The framework should strike a balance between any potential modifications of the design whilst maintaining pace of delivery.

We do not agree with the proposals for funding additional works. A case-by-case approach for costs above 50% of the original project capital costs creates uncertainty for bidders and could impact bids. We also support Ofgem's concerns around 50% of costs being recovered as fast money – this would place significant additional costs on consumers today and is not acceptable for intergenerational equity reasons.

Paragraph 6.11 seems to suggest that a CATO would request that Ofgem runs a design and build tender if the unit costs do not reflect market prices due to factors which are not reflected in the index (such as supply chain issues). We believe that the intention is that the CATO would request permission from Ofgem to run a design and build tender and for it to be overseen by Ofgem. We would be grateful for clarification on this point.

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

We are concerned about the proposal for actual debt costs to be passed through to the TRS, and ultimately consumers. As detailed in the EC-I update, all bidders will use the same assumptions on the cost of debt, provided by the Procurement Body and following the PPWCA, the CATO will run a competition to secure the debt. We are concerned that this places a significant risk on consumers if the CATO increases gearing and/or secures innovative or complicated debt structures that increase the financial risk around the project and risk of distress.

We would welcome clarity on what aspects of the debt competition will be fixed by the Procurement Body and how this process will be overseen.

We agree with NESO's position in relation to exposing consumers to both the upside and downside risk of debt refinancing. At the PPWCA stage the framework provides a pass-through mechanism for the actual debt terms secured by the CATO which is equivalent to passing through costs of refinancing during the asset lifetime. A gainshare provides an incentive for CATOs to refinance and allows consumers to benefit from this where costs are lower. We believe that this proposal should be revisited once there is greater clarity on the kinds of debt finance options that are being made available to CATOs.

Whilst we agree with a gain share on debt, we think additional clarity is required in a scenario where bidders receive debt costs as a pass through but then there is potential for gain from refinancing at a later stage. We welcome more clarity on how the arrangements around refinancing could evolve and how much flexibility there would be on when this can happen so that CATOs can take advantage of market conditions that would result in benefits for consumers.

We would also welcome clarity on paragraph 7.12 and how this might work in practice; without sight of how the margin will be set for operations and maintenance at the end of the revenue period, it is unclear how bidders should set this margin in their bids.