

James Norman
Transmission Competition Policy Team
Ofgem/Ofgem E-Serve
9 Millbank
London, SW1P 3GE

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Infracapital's response to the consultation on "*Extending Competition in electricity transmission: arrangements to introduce onshore tenders*"

Section 2 - Identifying Project for Competition

Question 1: What are your views on the proposed detailed interpretations of new, separable and high value (the 'criteria')?

In responding to this question we have addressed each of these criteria in turn.

"High Value" – Whilst we recognise the importance of demonstrating value, we believe Ofgem should not consider the £100m threshold as fixed and that the "value for money" analysis should be update if/when; (1) – Ofgem is able to tender multiple projects simultaneously leading to a reduction in bid costs and (2) actual costs savings and CATO costs are better understood.

"New" – It is clear that the CATO regime is primarily associated with delivery of new infrastructure, however we do not think that existing infrastructure should limit appropriateness of projects or lead to inappropriate boundary definition. We agree with CEPA report that "substantially new" may be more appropriate. We do not consider the transfer of existing assets to the CATO as a limitation, as long as there is sufficient information on the condition/refurbishment of the asset, as any issues with the existing equipment would be identified in the due diligence undertaken.

"Separable" – We concur that electrical separability at each interface is not a prerequisite. Whilst it is favourable it is not fundamental to the delivery and operation of the assets as long as there is operational and contractual clarity.

Question 2: Under what circumstances do you think asset transfer from an existing asset owner to a CATO would be required, recognising the principle that projects identified for tendering should be new?

It is anticipated that most CATOs will not involve the transfer of existing assets. However, it is reasonable to expect that existing assets will be transferred from an existing owner when;

- it makes operational/technical sense from a boundary definition perspective; and

- there is an opportunity for Ofgem to tender multiple transmission projects separated by a relatively small number/value of existing assets as a single project increasing value for money for the consumer.

Question 3: What are your views on our proposal that electrical separability should not be required at each interface, but that the SO can propose it to us if it thinks there is a cost-benefit justification based on system operability?

As noted above, we concur that electrical separability at each interface is not a prerequisite. We also concur that if the SO believes that there is a cost benefit justification then electrical separability could be considered.

Question 4: What are your views on the suggested process and roles for identifying projects for tendering? We have proposed specific roles for the SO – do you think there are any additional roles the SO could take on to support competition? What’s the most appropriate way to ensure that the network options assessment (NOA) considers the widest range of network options, including those that would be tendered?

We are satisfied with the role of the SO and therefore do not have any further comments. Comments on the management of conflict are provided later in this response.

Question 5: What incentives and obligations should the SO and TOs have for undertaking preliminary works for tendered projects, and is there any value in considering a success fee incentive?

We agree that it is important that the SO/TO is incentivised to deliver the preliminary works on time and to the appropriate quality. To achieve this a form of monetary success fee may be necessary along with ongoing monitoring by Ofgem to ensure that the scope of activities and associated outputs are appropriate. The Ofgem review may also be important to ensure that the preliminary works are not “over specified” by the SO/TO in maximising any associated fee. The success fee needs to be linked to the timely success of the appointment of the CATO and must be set at a level that incentivises the SO/TO but does not place a burden on the value for money of the project.

In undertaking its Due Diligence, the CATO bidders may identify issues of incompleteness and/or quality with the preliminary works. To ensure that no bidders are penalised in this respect, the tender process should allow/support the harmonisation of any issues with the preliminary works, to ensure that bidders are bidding on a consistent basis. This will require Ofgem to review bidder comments/feedback and provide technical guidance during the tender process.

Question 6: Should CATOs pay for the preliminary works at the point of transfer?

The value of the preliminary works are expected to be relatively low and therefore we do not have strong preference for either the CATO paying for the preliminary works at appointment of the CATO or for the SO/TO be funded directly by the consumer. In consideration of the fact that it is reasonable to expect future consumers to pay for the

works, it might be considered to be more reasonable for the CATO to pay the SO/TO for the preliminary works and for the SO/TO to refund the consumer through TNUoS charges. It must be ensured that any payments to the SO/TO do not disadvantage bidders or give a particular advantage to any bidder associated with the SO/TO.

Section 3 - How will the tender work and what will CATOs get?

Question 1: What are your views on our proposed late CATO build tender model? Do you have any views on the basis of bids, use of cost-sharing factors or what risks, if any, it would not be efficient for a CATO to manage during construction?

On balance we consider that the TRS model is the best approach for CATOs, supported by a competitive tender process. We consider the RAV based approach adopted under the RIIO framework to be more appropriate for large portfolio of assets of various ages and types, in which there is an ongoing requirement for investment capex and as a result operating costs change over time, all of which cannot be predicted or fixed through a competitive tendering regime. We have provide commentary against some of the key consideration below:

Competitive Bidding/Basis of Bids

We agree that it is reasonable to assume that competitive tendering will provide sufficient pressure for tenderers to bid economic and efficient costs, and that risk sharing measures may distort the bid process, encouraging artificial behaviour by the bidders. Ofgem will have the ability to benchmark the costs of bidders by comparing them to previous tendered projects as well as the RIIO-T1 costs. However, it should be noted that OFTO bid costs have become prohibitive to new entrants in the OFTO regime.

As noted in the consultation documents it will be necessary for there to be cost reopeners for specific risks with capex and project delivery, including the following, in addition to those measures under the OFTO regime;

- FOREX
- Financing costs beyond commitment periods
- Unexpected ground and contamination risk
- Unusual weather risk
- Change in design, standards and specifications
- Changes in law
- Changes in consent, planning conditions
- Consideration of any other risks identified through shortcomings of the preliminary works

As noted in the consultation documents the basis of the bid will be a tender specification prepared by the SO informed by; general system requirements, connection requirements, design and planning requirements and preliminary works information. The tender specification will be fundamental to the bid process and we expect Ofgem to further consult on the detail of the specification. Key considerations

are to ensure that the specification does not favour the TO or other TO bidding businesses e.g. allowing procurement of suppliers unrestricted by existing TO specifications.

Timing

We concur that the tenders should be run as late as possible in the project development process to maximise project certainty, without risk to the overall delay to the operation of the assets. However, Ofgem need to ensure that there is sufficient time in the ITT phase for tenderers to address any design condition constraints resulting from the parallel planning process. Ofgem may need to consider an option where a TRS is revised (incorporating planning requirements) post PB announcement and assessed by an independent party based on industry experience and the original tender submission, rather than recommencement of the tender process.

Overall we consider the durations of the tender programme to be reasonable for most projects, though we expect that most projects will require an 8 month ITT process.

Question 2: What are your views on our proposed early CATO build tender model? Do you have any views on what tender specification would best facilitate innovative but deliverable bids, and how we can best manage cost uncertainty after the tender?

Overall we are supportive of the early CATO build tender model and the potential to deliver commercial benefits and innovation in the design and consenting of assets, as well as their procurement, construction and O&M. We concur that;

- it will not be in CATO model. Some specific points to consider in due course include (not exclusive);
- reimbursement of CATO costs if the project fails to proceed through the final check point;
- the approach by Ofgem adopted in evaluating a broad range of tenders and solutions and the tender specification required to support this evaluation in consideration of the fact that bidders are providing a "best indicative cost";
- impact of consenting and other stakeholders requirements leading to fundamental changes in the design/option adopted by the preferred bidder, and the overall fairness of the tender process if unsuccessful bidders had proposed a more robust solution with this respect *i.e. bid deliverability*;
- the detail of the evaluation process to ensure a fair and transparent process when the project requirements are relatively undefined and the bids are largely indicative including the approach to cost variations;
- the level and timing of milestone payments; and
- the process in which returns are adjusted and/or savings are shared as it will be important that the required equity hurdle rate returns which formed the basis of the bid are not compromised risking the ability of the preferred bidder to reach Financial Close.

With respect to cost certainty after the tender we recognise that whilst the TRS for construction and operations are to be indicative, a degree of cost certainty can be provided by the provision of a schedule of costs for the components and the elements

of the design and reasonable variants to form the basis of any variation on completion of the design and development of the project.

With respect to the tender specification, we concur that whilst a tender specification based on a *preferred solution* reduces the potential for innovation and alternative solutions, it will result in more transparent and robust tender process. In addition;

- the tender specification will need to include operational performance requirements and an assumed availability incentive mechanism; and
- consideration needs to be made on the provision of information to the Bidders for them to complete the necessary system studies and the assessment of the design in the tender evaluation.

Question 3: Do you have any views on the best way to tender projects that use high voltage direct current (HVDC) technology?

We agree that the tender process needs to consider the HVDC technology and supplier solution adopted in the development of the planning application and therefore agree with the approach adopted by Ofgem. This may include the procurement of the converter station by the SO before transferring to the CATO. However, to ensure that bidders are able to propose innovative alternative technical and procurement solutions an option for bidders to provide a variant bid which complies with the planning envelope could be provided in the tender process. For example bidders may have the ability to procure alternative equipment more economically than that proposed by the TO/SO. This benefit will need to be considered against any costs incurred by the TO/SO through the early procurement of the technology supplier and Ofgem will need to ensure there is no “gaming” by bidders.

In consideration of long equipment lead times such as subsea cabling, we recognise that the TO/SO may have to procure equipment early to meet the required operational date requiring the repayment of capital invested. In this instance Ofgem will have an important role protecting the interests of the consumer in ensuring that any deposits or early selection of suppliers does not unduly influence the value for money of the project or act as an impediment to using a CATO solution. We also expect lead times to change and note that Ofgem will need to constantly review industry lead times to ensure that the value of the works procured by the CATO is maximised.

Question 4: Do you have any views on our proposal to prioritise late CATO build? Do you have any views on specific circumstances where early CATO build might lead to better outcomes than late CATO build?

We agree with the proposal to prioritise the development of the late CATO build model for the following reasons;

- To successfully prove the CATO concept, regulation and tender process before embarking on the more complex early CATO build model;
- To allow CATO companies/consortium to form and become established under the late CATO build model and subsequently develop the financial and human resource to lead the early development activities required under the early CATO model; and

- The status of the projects in RIIO-T1 which will qualify the CATO regime are likely to naturally support the late CATO model.

Question 5: Do you have any views on how we could mitigate the risk of a CATO not being in place?

We concur that a CATO of last resort mechanism and other OFTO mechanisms will form an important mitigant to the risk of a CATO not being in place. We also recommend that Ofgem consider other controls and reporting requirements to ensure that CATO's progress in development and delivery of the project is aligned with the required operational date.

Question 6: What are your views on our proposed revenue package for CATOs? Do you have any views on the proposed duration of the revenue term, including how it links to the asset cost recovery period, and whether operations and maintenance costs can be fixed over this period? Do you have any views on our proposed approach to indexation, refinancing and enabling new asset investment?

We generally concur that a fixed term availability bid based revenue stream to be the most appropriate for discrete point to point assets where the design, delivery and operation of the technology is well understood. Key considerations are discussed in turn below.

Duration

The duration of the fixed TRS will be a balance of asset/major component life and the ability to make use of long term efficient debt. We concur that a whilst a 25 year revenue stream is an appropriate revenue term facilitating efficient and competitive financing, a 30 year TRS is likely to be possible in the financing markets and offer better value for the consumer. As seen in similar asset classes, investors are willing to take a long term view in what is a mature industry. Over this period it should be feasible to fix operating costs, with the exception of any new/novel technology, such as converters for which the Licence should have a reopener for certain types of equipment. To mitigate the risk of bidders bidding tactically low on the associated opex, Ofgem will need to review the bidder assumptions and justification for the costs and consider any unrealistic costs in either a TRS adjustment or robustness score.

We recognise that 25/30 years is less than the economic asset life and therefore the assets will have a residual regulatory asset life. The residual asset value will drive financing considerations and therefore as a result it will be important that Ofgem provides clarity and certainty on the guaranteed residual asset value. It should be expected that the Licence will provide separate incentives and hand back provisions for the CATO to hand back the assets in the appropriate condition in line with other industries. The value for money benefits and requirements of a performance bond are unclear as the CATO is incentivised to maintain the assets as required to ensure a final payment is provided for residual asset value.

Indexation

We agree that a partially indexed revenue stream with the proportion determined by the bidders to be the most appropriate indexation option. It allows bidders, to

determine the most cost efficient indexation solution either through a natural hedge or any additional income through inflation linked derivatives, and the consideration of both fixed and index linked finance products. This approach is likely to provide the best value for money the consumer by allowing the market to match inflation exposures of costs and revenues.

We acknowledge the Government's drive towards CPI linked liabilities and the debt markets are responding accordingly, however given that a large proportion of inflated costs are RPI linked it would be appropriate to maintain a proportion of indexation linked to RPI.

Refinancing

We recognise that senior debt refinancing gain share is a standard approach adopted on public private partnership contracts, and do not think a reasonable gain share mechanism will discourage investors in bidding or refinancing delivering benefits to the consumer. Further consideration and consultation needs to be given to the basis of any refinancing gain share given that it is likely that refinancing assumptions will be included in the bidder assumptions. Overall the mechanism needs to be balanced encouraging innovation and competitive behaviour by the private sector.

Enabling New Asset Investment

Over the CATO licence period there may be the requirement for incremental capacity increases and consequently capex increases. Considering the integral role of the CATO in the transmission network it is reasonable to expect that the CATO will be obliged to undertake incremental investment to provide incremental capacity, and this obligation to be more prevalent than in the case of OFTOs. The higher obligated threshold could be in the order of 50%, compared to the 20% applied offshore. This enhanced obligation will reinforce the integral role of the CATOs and ensure that ownership boundaries remain as distinct as possible. It can be reasonably expect that most successful CATOs will have the ability to deliver and finance incremental capex, in normal market conditions. However, in consideration of this there should be a number of regulatory mitigants which may include;

- the works to be done on an open book basis with incentive mechanisms to ensure that there is no increase risk to the CATO but with incentives to minimise capex and to deliver on time and budget;
- the rate of return of the incremental equity investment to be the same as that agreed on award of the CATO licence;
- depreciation and residual value to be agreed in advance as per the original tender; and
- Force Majeure provisions in the event of unusual market financing conditions, as an example.

Question 7: What are your views on our proposed package of financial incentives for CATOs? Do you have any views on how we could structure an availability-based incentive to ensure CATOs operate their assets with a 'whole network' view? Do

you have any views on whether there are circumstances under which 'payment on completion' would not be appropriate to incentivise timely asset delivery?

Financial Incentives

We have considered the incentive for timely delivery of the CATO assets above. Other incentives are discussed below. In principal and in recognition of the overall objective of maintaining a transparent and simple incentive mechanism as possible, we would not propose any additional financial incentive mechanisms (other than the availability incentive), unless it is clear that a financial incentive is the only (or by far the most appropriate mechanism) to encourage the correct behaviour.

Losses – We do not consider the need to penalise losses during operation as they are primarily a design consideration. Losses could therefore be considered in the assessment of the Preferred Bidder using an open and transparent scoring methodology considering whole life cost of the proposed solution.

Innovation – We concur that bidders are incentivised to be innovative in the delivery and operation of assets to be able to offer competitive proposals. Overtime as CATO organisations become more established they will have the opportunity to participate in the Network Innovation Competition providing further evidence of their proactive approach to innovation. A financial incentive is therefore not required.

Environmental Performance – We concur with CEPA that environmental measures can be assessed as part of the bids at ITT stage including; management of visual and noise impact, SF₆ leakage rates and CO₂ emissions. Other behavioural drivers include planning conditions, environmental management systems and compliance with the relevant environment regulations should be sufficient to drive the appropriate environmental behaviour.

Operational Behaviour (i.e. appropriate outage timing and planning, working with others) – behavioural interactions defined in the STC and its procedures, and through the Network Access Policy in which compliance could be referenced under the CATO Licence should define the appropriate behaviour.

Delivery of Connections – As for the TOs under RIIO, it is reasonable for the CATO to be incentivised in the timely delivery of grid connections. However, it will be necessary for an appropriate process/timeline to be developed considering the impact on TRS (discussed above) and the large number of stakeholders involved.

Availability Based Incentives

We concur that an availability based mechanism overall is likely to be the most appropriate incentive mechanism to drive the right behaviour and offer best value for money. From our experience on OFTOs the availability based mechanism has;

- incentivised the OFTO to maximise availability;
- encouraged best practice in the OFTO undertaking planned maintenance activities to minimise outages incurred whilst also maintaining good asset condition;
- been clear and well understood supporting competitive funding solutions; and
- provided with a reasonable balance of risk and reward.

Overall we consider that moderate coefficients to optimise the availability incentive i.e. capacity, unplanned maintenance weightings neither have a significant influence on behaviour nor change the risk profile to the OFTO/CATO. However consideration needs to be made where the CATO assets provide energy to more than one customer i.e. there is more than one direct connection to the assets.

Payment on Completion

It is recognised that the commencement of TRS following energisation of the transmission assets will provide clear financial incentives for the CATO to complete construction without the need for complex incentive mechanisms. However, in some circumstances where the project has sufficiently large capex, a significant development period and/or a long construction period, liquidity problems may justify pre-funding. These circumstances may include;

- a construction period of greater than 4 years;
- a capex value in excess of that supported by market conditions/limitations at the time; and
- long and/or expensive development periods or early CATOs.

Overall an optimum balance needs to be achieved between risk transfer and value for money and in the circumstances identified above it may be necessary to include sectional completion payments, for example lump sum payments for achieving planning etc for an Early CATO, which could efficiently reduce private sector carry costs.

Question 8: Are there other types of incentives not covered in this chapter that you think should apply to CATOs?

We currently are not aware of any other incentives which should be applied to CATOs.

Section 4. - Managing conflicts of interest

Question 1: Are there any risks or conflicts of interest arising from the SO's role that we haven't identified?

As noted above, the Tender Specification will provide an important role in supporting a competitive tender process, encouraging innovation and the involvement of new supply chain participants. We expect Ofgem to further consult on the detail of the specification. Key considerations are to ensure that the specification does not favour the TO or other TO bidding businesses e.g. allowing procurement of suppliers unrestricted by existing TO specifications.

Question 2: Are there any risks or conflicts of interest arising from the participation of incumbent onshore TOs that we haven't identified?

As you will be aware a number of industry contractor/suppliers are actively engaged in TO framework arrangements. These arrangements represent important frameworks for the contractor/suppliers, in which significant activity has been undertaken in recent years to demonstrate competence and win work from the TO. As a result a

number of contractor/suppliers may be reluctant to bid against TOs or potentially other TO bidding businesses. To ensure that a broad range of contractor/suppliers are able to participate with other CATO bidders, the bidding process/rules need to be designed to ensure that the TO or potentially other TO bidding businesses are not able to restrict competition through their framework arrangements.

Question 3: Are there any additional conflicts of interest that we haven't identified?

Please refer to Question 1 and 2 above, as well as references to conflicts in our response elsewhere..

Question 4: What measures do you think would be appropriate to mitigate the risks and conflicts of interest? What additional conflict mitigation measures would be needed if the SO takes on a broader role in supporting competition?

Overall it is important that Ofgem proactively addresses potential conflict of interests to ensure private sector participation in the CATO regime. For example, if a SO or TO has spent a significant period of time developing and designing a project there is a suspicion that this detailed knowledge will result in a unfair competitive advantage. Until these conflict points are proven to be unfounded, Ofgem need to make sure;

- i. the process is clear and transparent
- ii. bidder costs are kept low; and
- iii. there is a clear evaluation criteria.

Ofgem's role is critical in this process and we would anticipate that Ofgem will consult further on their role in managing conflicts as well as the detailed conflict management measures required of the TOs and the SO.