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Dear Mr Cope

Offshore Electricity Transmission: Consultation on the Enduring Regime Ref: 157/09

Frontier Power is pleased to have the opportunity to respond to Ofgem's consultation document on the enduring regulatory regime for offshore transmission. To date much attention has been focused on the transitional tender process. However, ensuring the build out of the transmission infrastructure for new offshore generators is clearly the most important objective of the offshore regulatory regime. Hence, it is important that the arrangements are designed:

- to ensure that sufficient investment is forthcoming over appropriate timescales;
- to ensure that there is scope for innovation in the design of the future offshore transmission infrastructure; and
- to ensure that there is sufficient competition for projects or groups of projects, in order to ensure that the regime achieves a good deal for customers.

We believe there is much to be commended in Ofgem's proposals as they stand. However, there are a number of areas where we believe further thought is required in order to ensure that the above objectives are satisfied. In this response, we comment specifically on:

- the issue of supply chain exclusivity;
- facilitating new entrants; and
- facilitating effective competition.

Supply chain exclusivity

The consultation document recognises that there are important concerns in relation to supply chain exclusivity. In particular, the document recognises that where there are a greater number of prospective bidders than there are supply chain component providers. Supply chain exclusivity could therefore significantly constrain the competitive process Ofgem has established to deliver for customers – in particular, it could reduce the scope for customers to benefit from:

- innovative design choices;
- innovative financing structures; and
- innovative management approaches.

Since competition in these areas is likely to provide the majority of the benefits from competition among OFTOs (the other supply chain components being relatively fixed in price terms), it would seem to be fundamental to the success of the regime to maximise competition in these areas.

The consultation document notes a concern that, were Ofgem to seek to preclude supply chain exclusivity, it would be difficult to enforce and have unintended consequences in relation to the engagement of equipment suppliers in the regime.

It is difficult to understand why Ofgem believes this to be the case.

First, there are already a wide range of regulatory obligations on the bidders in the OFTO tenders. It is difficult to see that an obligation not to enter into exclusive arrangements would be a significant or particularly onerous addition.

Second, it is relatively commonplace in commercial transactions (e.g. corporate M&A, outsourcing deals etc) for bidders in a competitive process to be obliged not to enter into exclusive arrangements with relevant parties (for example, advisors, subcontractors in specific areas). These obligations (effectively preconditions of participation in the competitive process) are imposed with a similar purpose in mind – i.e. to avoid bottlenecks in the supply chain reducing the competitiveness of the process.

Third, while it may be the case that unintended consequences could flow from an attempt to impose obligations on the equipment suppliers themselves, it is unlikely that sensibly structured obligations on potential OFTO bidders would result in equipment suppliers being less engaged.

For any given offshore transmission link, the probability of any one equipment supplier securing a role is independent of the number of potential OFTO bidders. It is competition between the equipment suppliers themselves that matters from this perspective.

Unless there is a “clear winner” amongst the potential OFTOs (something Ofgem are trying to avoid in attempting to generate effective competition), an obligation not to enter into exclusive arrangements should avoid the risk for an equipment supplier of having a limited number of potential OFTOs to choose from. In the limit, all suppliers could make an offer to all potential OFTO bidders (although for reasons of transactions costs, this is unlikely to be the outcome).

The alternative approach suggested by Ofgem (i.e. allowing bids on the basis of indicative costs and then allowing the successful bidder to hold its own tender) is unlikely to be effective unless it were also accompanied by an obligation not to enter into exclusive or binding arrangements at the time of the OFTO tender. Absent such an obligation, there would be nothing to stop some OFTOs concluding (but not revealing) binding and potentially exclusive arrangements with suppliers. This would allow them to submit, with greater confidence than others, an attractive indicative bid.

In summary, therefore, there are real risks to the objectives of the regime from exclusivity in the supply chain. Moreover, the reasons advanced by Ofgem for being cautious about precluding exclusive arrangements are unfounded. We therefore see no reason to structure a sensible prohibition on all potential OFTO bidders for any given project in relation to exclusive supply chain commitments.

Facilitating new entrants

Ofgem's consultation document notes that new entrants can be particularly useful in driving innovation. Further, the document cites examples in which arrangements to facilitate new entry have explicitly been put in place – e.g. the third generation mobile licence award and the EU ETS.

We agree there are complexities in relation to defining how similar arrangements to support new entry would work in the case of the OFTO tender process.

However, we believe Ofgem should avoid making a firm decision one way or other in this area until the outcomes of at least the first transitional tender round has become clear. In a situation in which one bidder managed to secure a significant number of the transitional projects, the balance of arguments in relation to facilitating new entry may change.

Facilitating future competition

Ofgem notes that a party which controls a particular cable route may find itself in a powerful position as the future offshore network develops. If third parties cannot effectively secure access to key cable routes, in combination with the fundamentally project based approach to tendering new projects taken by Ofgem, this could lead to:

- strengthening of existing positions and tilting of a level competitive playing field; or
- significant design inefficiencies (e.g. cable duplication) in the offshore grid.

Both would in turn lead to significantly higher costs for GB customers.

However, Ofgem's minded to position appears to indicate a concern in relation to requiring third party access to such cables (e.g. "... licence obligations and the provisions of competition law may be able to address these issues, and consistent with better regulation practices, we would not wish to unnecessarily duplicate regulations.").

The fundamental role of the regulator has always been to balance the benefits of intervention against the benefits of the market in a way which is in the best interests of the customer. In the situation where the cable route is (or could genuinely be) critical to other developments, it is not at all clear to us why the regulator would not see single ownership of that cable route as constituting an effective monopoly which requires regulation. It is just such arguments which justify all natural monopoly regulation onshore.

Furthermore, in a whole variety of contexts, Ofgem have consistently argued that broad licence conditions or worse, reliance on general competition law are insufficient. Neither creates confidence for investors. Competition law is ex post and hence addresses problems once they have occurred, and broad licence conditions will create debate and uncertainty where investors need clarity.

We therefore believe that the regulator needs to be proactive in this area. Clear and robust arrangements for interconnection of and third party access to offshore grid assets are essential if potential OFTOs are to have confidence that efficient, integrated grid solutions are possible.

Summary and conclusions

We remain committed to participation in the rollout of new offshore grid infrastructure, to support the achievement of GB's renewables targets. The enduring offshore regulatory regime is critical in this regard. We believe Ofgem's consultation document represents an important step forward – however, we believe further consideration is required in a number of areas to ensure that the significant potential gains from the competitive process are not lost to customers.

As ever, we remain happy to discuss our comments with Ofgem at any stage.

Yours sincerely



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