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Ofgem
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Dear Madam

RIIO-T1: CONSULTATION ON IMPLEMENTING COMPETITION IN ONSHORE ELECTRICITY TRANSMISSION

We would like to thank you for providing us with the opportunity to respond to your consultation. Please find below the response of Macquarie to Ofgem's consultation in relation to competition in onshore electricity transmission.

Macquarie is an active independent player in the offshore transmission market and welcomes the intended move to implement competition in onshore electricity transmission as well as to provide a greater role to third parties. The private pools of direct infrastructure investors which are likely to be interested in deploying capital into this space will assist Ofgem in achieving its target benefits to the end consumer. In particular, the range and depth of funding structures that can be brought into this space by independent third parties will prove invaluable.

Key Principles

Our response to the specific questions are outlined below, but to start with we outline a few overarching principles that will need to be implemented in a fair and transparent manner to achieve a framework that works for third parties and consumers:

- First, the framework needs to address and demonstrate to independent third parties how it achieves a real 'level playing field'. Should this not be the case, independent sponsors will not commit the resources (including bid costs) to the process and will instead pursue other opportunities which are perceived as "fair".
- Second, the process needs to give third party bidders the opportunity to deliver the full benefits of PPP type capital structures (as so strongly demonstrated by OFTOs Round 1).
- Third, incumbent TOs bring certain enduring price advantages: economies of scale, purchasing power, marginal cost pricing (particularly on operational issues).

The framework needs to give every opportunity for the efficiencies of economies of scale and marginal policy to find their way to the consumer. But this must be achieved without infringing the "level playing field" principle identified above.

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For example, if the incumbent TO intends to bid then it should share its O&M package and construction package with other bidders to ensure everyone in the market is able to benefit from the same marginal cost and purchasing power. For avoidance of doubt, this approach should be in addition to business separation and the transfer of early stage efficiencies gained in pre-bid procurement. A way to achieve this would be for the transfer agreement mentioned by Ofgem for pre-construction works to also include specific outputs of the incumbent TO negotiations.

It could also be considered that if an incumbent TO desires so, it could have an option to access a portion of the equity of the new licensed entity on the terms agreed by the third party selected through the selection process. For example, the Incumbent TO may have a last right (just before Financial Close) to participate in [25]% of the equity alongside the independent third party.

The abovementioned ideas seek to work towards a structure which will encourage new entrants, provide a level playing field and ultimately reduce the cost for the end consumer.

We have sought to follow the principles presented by Ofgem in the consultation dated December 2011 but we would like to highlight that we still strongly believe that a process where the incumbent TOs are not able to bid would deliver the most efficient competition. Incumbent TOs can indeed show concerns about grid wide performance or adopt a market wide strategic perspective that might overshadow ordinary requirements for return on capital.

We would be delighted to discuss these thoughts in an open and constructive manner with Ofgem.

Chapter 3

Question 1: Do stakeholders consider that we have correctly identified the changes to industry codes that would be required to enable third party involvement in onshore electricity transmission?

We believe Ofgem has identified the key changes that would be required. We would like to mention that out of the three broad possibilities in the STC for a third party TO, the one that would create a strong basis to facilitate new competition will be where the third party is more akin to an offshore TO with, in some ways, fewer obligations than a TO in Scotland or England and Wales. This would help third parties to consider and put in place different financing structures delivering more value for the end consumer (similarly to the financing structures used on offshore transmission and which led to the c.£350m benefits to the consumer over 20 years).

Question 2: Do stakeholders have any comments on the changes proposed to the industry codes in appendix 2?

We don't have specific comments. We note that the changes made for offshore transmission licensees should lead to minimal required changes. We also note that according to the competition model adopted, some specific changes might be required.

Question 3: Do stakeholders have further comments on the proposed process and timetable for enabling the industry code modifications?

We don't have specific comments. The process and timetable seem sensible and achievable.

Chapter 4

Question 1: What level of detail would be required for the following pre-construction outputs in order to hold an effective selection process:

- project design
- technical specifications
- route identification
- site studies
- environmental impact assessments and stakeholder consultation?

The level of detail of the construction outputs will lead to relatively more or less robust assumptions and contingency margins in the bids.

The more detailed pre-construction outputs are, the lower contingency margins will be. However, an effective selection process can start if the overall project design philosophy and technical specifications are provided without all specific details being determined yet. These two outputs would need to be the most advanced though.

As for route identification, site studies, environmental impact assessments and stakeholder consultation, an effective process can be conducted with a relatively low level of details if there is a clear mechanism of price adjustment in case unexpected and unknown costs and delays arise at a later stage due to missing information during the selection process. This would mean that significant discussions might occur post selection which could create delays.

Please note that where the incumbent TO can benefit from efficiencies and economies of scale in the procurement of this common design solution and technical specifications to be adopted by all bidders, these efficiencies should be made available to all bidders.

Question 2: Should planning consents be in place before the selection process?

We believe the best value would be achieved for the end consumer if planning consents are in place before the selection process. However, in a view to minimise delays to the start of construction works, we believe Ofgem's suggested two-stage selection process is achievable. Expressions of interests would then be subject to obtaining consents within a timeframe indicated by Ofgem and common to all bidders. The formal selection process would then occur when planning consents are obtained.

Question 3: Should land be purchased or wayleaves obtained by the incumbent TO before the selection process?

We believe land can be purchased and wayleaves obtained by the incumbent TO in order to minimise delays to the start of construction works.

We believe this can be done in parallel with the selection process as long as this is finalised before the end of the selection process and any uncertainties created are covered by a clear adjustment mechanism post-selection.

Similarly to pre-construction outputs, this would lead to significant discussions post selection which could create delays in some instances.

Question 4: What are stakeholders' views on the desirability of Ofgem seeking independent verification of the needs case and solution proposed by the incumbent TO in advance of any selection process?

Independent verification will help achieving better value for the consumer as well as ensuring the incumbent TO does not favour one solution over another in a view to gain a competitive advantage. This should give additional comfort to certain parties to consider participating to the selection process.

It would be desirable for this independent verification to also cover areas where the incumbent TO can benefit from efficiencies in order to make sure they are made available to all bidders.

Question 5: Do stakeholders have a view on whether pre-construction outputs could be retained by the incumbent TO or transferred to the eventual asset owner? Is there a difference depending on the output in question?

The outputs should be transferred to the eventual asset owner. Having the incumbent TO retaining them would create additional risks and costs and we cannot identify material benefits to this approach. This is relevant for all outputs. It is also more efficient to have the outputs efficient costs recovered by the incumbent TO and having a licence condition requiring them to make these outputs available to third parties. It will ensure competition while providing transparency and hence reducing costs.

Question 6: What kind of commercial arrangement, if any, should be used to facilitate the sharing or transfer of pre-construction outputs between an incumbent and third party TOs?

A simple transfer agreement between the incumbent TO and the third party TO can be used, and the purchase price being fixed as a result of the cost recovery assessment. All bidders should be required to assume the same cost and any adjustment should be applied after the selection process through a transparent process if required. See also our remarks re. transfer of efficiencies achievable by the incumbent TO thanks to its privileged position.

Question 7: Do stakeholders consider that the staged approach we have outlined, which would allow interested parties obtain a 'light touch' licence, is appropriate?

The staged approach could work subject to the following remarks.

It is unclear how the third package requirements would be complied with by a licensee and the related timing of certification.

The conditions that apply during stage 1 (the 'light touch' licence) should be limited to minor conditions and no onerous obligations should apply.

It is also unclear how the license would be treated for unsuccessful bidders at the end of the selection process.

Consequently, it is unclear to us which benefits such an approach would bring as compared to having the preferred bidder only applying for a licence and obtaining it before awarding the revenue stream.

Question 8: Do stakeholders agree that some form of business separation arrangements will be necessary for incumbent TOs?

We agree. It will ensure there is actual competition with a 'level playing field' between parties. We believe some parties might not consider being involved in a selection process if there is no such assurance and the incumbent TO can make decisions to gain a competitive advantage.

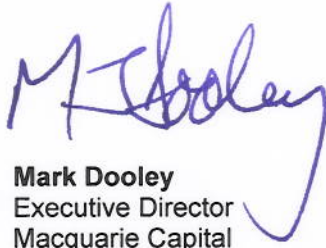
We believe that this is not sufficient to generate appetite from third parties though and given it makes sense to have the end consumer benefit from any efficiency achievable by the incumbent TO, we believe these efficiencies should be identified, documented, made available to all bidders and eventually transferred to the selected bidder. We also believe incumbent TOs should be given the option to provide commercial offers, in particular for the operations & maintenance of the assets.

Question 9: What form of business separation arrangements do stakeholders feel would be appropriate for incumbent TOs?

It is critical to ensure incumbent TOs are not in a position to make decisions in order to gain a competitive advantage. Consequently, the clearest separation would be appropriate i.e. establishing a separate licensed business. This will ensure a 'level playing field' with third parties and maximise the appetite from various parties to participate in the selection process, which will eventually lead to better value for end consumers. Again this separation should be accompanied with measures to ensure efficiencies are identified and made available to all bidders.

Yours faithfully

Macquarie Capital (Europe) Limited



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