

Charlotte Ramsay
ITPR Team
Ofgem
9 Millbank
London
SW1P 3GW

1st August 2013

Dear Charlotte,

ITPR – Emerging Thinking Consultation

Transmission Investment is a leading player in the competitive transmission market: we manage four offshore transmission owners, and are preferred bidders on a fifth through our joint venture Transmission Capital Partners. We are developing an interconnector project with French grid company RTE, the France–Alderney–Britain project, and we are keen to deliver onshore transmission assets if and when this area is opened to competition. Thus we are active in all of the areas of transmission that ITPR is seeking to unify.

In responding to this consultation we set out our key high level comments in this covering letter, while responding to the specific consultation questions in the attached Annex 1.

There are three key issues where we have particular concerns that we wish to highlight:

- i) Business separation between the System Operator (SO) function and the rest of National Grid.
- ii) Interconnector projects' urgent need for regularity certainty.
- iii) The introduction of competition for the delivery of onshore transmission assets.

On the first of these points, we are concerned that Ofgem appears to be considering substantial increases to National Grid's SO powers without full business separation.

It is widely recognised that there needs to be strict separation of the monopoly system operator role from competitive generation businesses; indeed this is demanded by European legislation. The same level of separation needs to be in place between National Grid's SO function and all its transmission businesses.

If there is an option of competitively awarding onshore transmission assets, or if competitively-granted offshore transmission assets can undertake the same role as

monopoly onshore assets, then even traditional onshore TOs should be considered as competitive transmission businesses. Even if they are not allowed to bid in the competition they may still compete by trying to ensure that the competitive process is never applied to assets they wish to own, or by trying to ensure that grid designs only specify assets that are classed as not subject to competition.

Therefore same level of separation needs to be in place between the monopoly system operator role and all transmission businesses as there is between transmission system operation and generation. As our analysis (see Annex 2) shows National Grid's current arrangements fall far short of what would be required by this criteria.

Our second point is that at present the development of interconnector projects is being slowed by a lack of clarity regarding how these would be regulated. No thinking on this subject seems to have emerged yet from ITPR. Ofgem has stated that it will not be opening up the cap-and-floor mechanism to projects other than NEMO until at least next year. This means that developers don't just lack an enduring approach – there is no existing regulated approach either.

We propose that for Projects of Common Interest, which according to the Infrastructure Regulation should receive special treatment to ensure their accelerated development, Ofgem should:

- i) Immediately – review the economic case for each project as soon as it is submitted by the developers (some economic cases have already been submitted and have been awaiting review for some time). Ofgem should aim to rapidly reach a conclusion on whether each project, in principle, merits a regulated rate of return. (It would not be decided at this stage whether this would be fixed or cap-and-floor in nature). This could be based on the approach that Ofgem takes in assessing the needs cases for major reinforcements such as the recent Hunterston-Kintyre cables.
- ii) As soon as possible – develop a proposal for incentive regulation of rates of return, in line with the requirements of the Infrastructure Regulation and the good practice recommendations to be made by ACER before the end of this year.
- iii) Within 12 months – specify the details of the regime.

This approach should provide interconnector developers with an increasing level of certainty, allowing them to continue to progress their projects and meeting the Infrastructure Regulation's overall aim of "the most rapid treatment legally possible".

Our third point is that Ofgem's long-term aim should always be to make use of free and open competition rather than regulated monopolies unless there are particular special circumstances ("natural monopolies", etc). The offshore transmission regime has already demonstrated the savings to consumers that competition can bring and this should be extended to other areas of transmission.

We accept that there may be some areas onshore where competition is impractical or undesirable (e.g. where the asset value is small relative to the transaction costs) and we also accept that Ofgem may wish to introduce competition in a staged, progressive manner, but nevertheless there should be an underlying preference for competition over monopoly.

We hope that you find our responses helpful. We would be delighted to meet you to discuss them in more detail.

Yours sincerely

A handwritten signature in blue ink that reads "Sean Kelly". The signature is written in a cursive style with a blue ink color.

Sean Kelly
Partner

ANNEX 1

RESPONSES TO SPECIFIC QUESTIONS

Question 1: Do you think we have appropriately characterised the future challenges to network development? Where do you see the main challenges? What are the long-term strategic and sustainability implications of these challenges?

We agree that the British grid faces a significant challenge in financing and delivering the substantial investment required for asset replacement, interconnection and the shift to low carbon generation.

Furthermore in addition to the volume of transmission assets being added, the nature of these assets is changing, with traditional onshore assets set to fall to just 30-40% of the total¹.

This high level of investment shows an urgent need to maximise the efficiency of building and financing of these assets. This, along with the move towards very large (often offshore) projects creates an environment where increasing competition in transmission ownership has the potential to provide significant benefits.

We also agree that multipurpose projects have enormous large – and as yet untapped – potential to reduce costs. Our calculations for the connection of generation to the France-Alderney-Britain project, for instance, show savings of hundreds of millions of pounds relative to exporting tidal generation to Britain via a radial cable.

Question 2: Are any of the review areas under ITPR more relevant than others?

The main text of this letter describes the areas that we believe are particularly important.

Question 3: What are your views on the options for system planning discussed in this chapter? Are there other approaches to system planning that you think we should be considering within the ITPR project?

We agree with the concept shown in Figure 1 – i.e. that the possible options for system planning are a function of the depth of the SO co-ordinating role and the degree of separation between the SO and the rest of National Grid.

¹ Based on Table 1 in the companion report by Imperial College & Cambridge University. The calculation ignores depreciation.

However we are concerned that the degree of separation titled “*increased transparency or business separation*” covers an excessively wide range of possibilities from negligible changes (e.g. publication of additional data to improve transparency) to meaningful separation (e.g. our suggestions, as set out in Annex 2).

Also, as noted previously, the SO needs to be fully separated from National Grid’s competitive businesses – and this includes the onshore TO business. Even if the onshore TO business is not allowed to bid to own competitively-awarded transmission assets they will still compete by trying to ensure that the competitive process is never applied to assets they wish to own, or by trying to ensure that grid designs only specify assets that are classed as not subject to competition.

Figure 1 could therefore be read as suggesting that even a minimal level of additional separation could be sufficient to allow very substantial increases in National Grid’s power. We are very concerned with this possibility, and suggest that more information is necessary on the additional powers that would be provided to National Grid and the additional separation measures that would be taken.

Question 4: Do you think that it would be beneficial to strengthen the role of a coordinating body working with relevant parties to facilitate efficient decision-making? In what areas could this coordinating body add most value to the process?

Our understanding of the “enhanced” and “directive” models is set out below:

- i) Relative to existing arrangements, in the “enhanced” model:
 - The SO becomes responsible for identifying strategic needs.
 - The SO will work with the TOs to identify reinforcement options – which presumably means that it will have its own power system analysis, design and cost estimation functions – and will decide which one will be recommended to Ofgem

- ii) Relative to the “enhanced” model, in the “directive” model:
 - The SO becomes responsible for the “funding request”. We assume that this is a reference to the submission to Ofgem of a Need Case for the project, it then being for Ofgem to decide which TO is granted the right to build the project and to receive the associated revenue stream.
 - The SO will obtain project land and environmental permits in its own name, with these then being transferred to the selected transmission owner.

On the basis of this understanding of the models, we offer the following comments:

- i) It appears to us that the proposed shift towards the SO identifying strategic needs may already be happening (though we would caveat this by saying that it can be difficult to distinguish between National Grid’s TO and SO functions).

- ii) If the SO will always have the final say over which reinforcement option is taken forward, we would question whether there is any point in onshore TOs retaining staff in areas like power system analysis where they would duplicate the SO's staff².
- iii) Having environmental permitting undertaken by the SO in the directive model is potentially an attractive option in terms of facilitating competition in transmission, particularly if combined with a truly independent SO. If the SO has obtained land and permits then all would-be TOs will be able to compete on a level-playing-field basis to build and own the assets.

We agree that the enhanced and directive models have the potential to facilitate efficient decision making. We also note that the directive model, in particular, also has the potential to strongly benefit competition.

However any such benefits are likely to be more than offset by the conflict-of-interest disbenefits that would result if the depth of the SO's role is increased without adequate measures to separate it from the rest of National Grid. We discuss this further in our response to question 5 below.

Question 5: What are your views on the (real or perceived) conflicts of interest that could occur from parties holding dual responsibility in system planning and asset delivery and ownership? What are your views on potential options for institutional arrangements, separation and transparency measures to mitigate this?

There are clear conflicts of interest if the SO is affiliated to a company competing to own transmission assets. Concerns include:

- i) More favourable treatments being given to in-house interconnector or multi-purpose projects in terms of firm grid access and/or declared wider grid benefits.
- ii) Showing a bias towards reinforcements whose assets are normally not subject to competition and are in their affiliate's service area.
- iii) Developing and permitting projects (with the "directive" model) in such a way that it is difficult to use project finance if their affiliates do not use project finance but most competitors do.
- iv) Claiming that projects are of such urgency that there is no time for competitive processes.

² Rather than have grid design engineers employed by the TO, where they would come up with alternatives to the SO's designs that would doubtless almost always be rejected by the SO, it would be more efficient if everyone worked at the SO.

- v) Giving the impression to the developers of external renewable generation that the SO will give a more favourable treatment to their project under EMR if their affiliate is involved in providing the transmission.
- vi) Subjecting assets owned by their affiliate to less stringent tests and inspections than those owned by competitors.

Complete independence, as suggested by Imperial College and Cambridge University, would be the ideal solution – immediately removing all of these issues. If this is believed to be impractical then at a minimum Ofgem should look to implement the measures set out in Annex 2 which are based on the EU's rules for separation between SOs and competitive (generation) businesses.

We believe that a suitable set of separation measures would avoid the need for establishing any new entities.

Question 6: What are your views on potential future approaches to planning interconnection? Should there be increased central identification of potential interconnection that could benefit GB consumers?

We agree with Ofgem's conclusion that there currently "*Numerous factors, including the risks inherent in the exemptions process and a lack of compatibility between the merchant approach and the regulated regimes of neighbouring systems*" that are driving the need for the merchant model for interconnection to be supplemented by an alternative "regulated" approach. As an interconnector developer our own assessment of opportunities reached exactly the same conclusions.

We also agree that this raises questions regarding the planning of non-merchant ("regulated") interconnector projects, and we agree that approaches based on centrally-identified and developer-led non-merchant concepts are not mutually exclusive. We note that central identification ("SO-led") interconnector development would work best under the "directive" model of SO depth with the SO presenting the Needs Case to Ofgem for interconnection. We would then advocate competitive delivery of the required interconnection capacity.

We can see no reason why the owners of centrally identified interconnector projects should be exposed to market risk: this would have the effect of increasing cost of capital, and hence cost to consumers, without any benefits in terms of incentivising efficient development given that the risks wouldn't be taken by the SO. It is our view that in this situation the best approach to regulating the interconnector owner would be to use the framework created for "OFTO-build" projects (i.e. a fixed revenue stream based on competitive bidding, along with availability incentives).

Even if central identification of interconnector projects is introduced, however, a role will remain for developer-led projects since:

- i) Some projects (notably multi-purpose projects and renewable-import links) will – by their very nature – be instigated by generators³.
- ii) Similarly there may be multi-purpose projects which – by their very nature – are instigated by power consumers (e.g. connection of offshore oil and gas platforms to interconnectors).
- iii) There should be mechanism whereby existing projects that are already underway as developer-led projects can continue without disruption and delay.

More importantly, we believe that developer-led projects may need to remain the dominant approach if the level of separation between the SO and National Grid is inadequate. If the separation remains at the current level (possibly with “improved transparency”) then parties other than national Grid are likely to be deterred from bidding for rights to build and own new links.

Developer-led projects could be delivered on a “cap and floor” basis (with some transfer of risk to the developer) or with fixed regulatory returns. It is likely that each approach will be better suited to different situations:

- i) Where there is doubt over the economic case for an interconnector the cap-and-floor approach will reduce risks to consumers and ensure that the project will only go ahead if the project’s financiers are convinced that it is economic.
- ii) In most cases though we think that there will be strong economic and/or strategic reasons for the construction of an interconnector. In these cases a fixed return will give a lower cost of capital, and hence lower tariff requirements for the owners and higher benefits for consumers. Furthermore fixed returns will avoid the problems such as under-sizing of the link that occur with cap-and-floor arrangements as they do with merchant.

Question 7: What are your views on the options for delivery of transmission assets discussed in this chapter? Are there other options that you think we should be considering within the ITPR project to address the delivery drivers and challenges identified?

We agree that competitive delivery and delivery by incumbents are the alternatives that should be considered. We comment on the level of flexibility in choosing between competitive and incumbent delivery in our response to the next question.

The choice of “delivery” method should – as the name suggests – be about how new assets are acquired by transmission companies. It should not imply that the ownership of assets already owned by a transmission company should change.

³ Potentially with assistance from transmission developers.

Question 8: Do you think that it would be beneficial to introduce some flexibility in the existing regimes to provide for alternative delivery routes, where this is in the interests of consumers? If so, what criteria could be used to determine the delivery route for an investment?

We agree that a high level of flexibility should be introduced but only where classes of asset which are currently subject to monopoly ownership can be opened up.

We see the reverse process – removing competition and replacing it with a monopoly where there is no “natural monopoly” – as a retrograde step and inconsistent with the concept that regulation should act in lieu of competition in situations where competition is impractical; it shouldn’t act to create and enforce unnecessary private monopolies.

We suggest that the following criteria could be used to determine the delivery route:

- i) There should be an underlying regulatory aim to use competition in place of monopolies wherever possible. Even if it is decided to initially restrict competition to narrower areas the long term strategy should be for these areas to steadily grow.
- ii) The size of asset in question. Clearly for smaller assets the transaction costs associated with the competitive process could make it inefficient.
- iii) The competitive approach is easier to apply to distinct assets not requiring access to incumbents system except for connection at either end (so, if all other things are equal, we would expect a “bootstrap” to be easier for a competitively-awarded TO to deliver than, say, reconductoring of another TOs overhead line). Over time, as the practices of competitive transmission ownership become more firmly established, we expect that this issue will become less of a constraint.
- iv) Competitively selecting an asset owner is clearly a fair approach when the funds for the development of a project were provided or underwritten by consumers. In contrast where a non-regulated monopoly developer has led a project⁴ and put their own funds at risk in its development it would seem unfair to refuse to allow them to build and own the link.

However we would recommend that speed should not be a criterion in selecting between competitive and monopolistic delivery, since:

- i) We are sceptical of arguments that competitive processes to decide on the asset owner will introduce delay, given that there will in any event be a competitive process to select manufacturers and installers.

⁴ Presumably a project that originated before competition was introduced.

- ii) Having speed as a criterion may create a perverse incentive for monopoly transmission companies to introduce delays into project development. The delaying entity then claims that there is insufficient time for competition, and therefore that they be awarded the project. A particular concern arises where the SO is owned by National Grid and has a role in project development.

Question 9: If we pursued additional flexibility in application of the regimes, what role should discretion play in identifying the delivery route for a particular investment?

We understand that there is a justification for an element of discretion – without this there is a risk that innovative multi-purpose concepts will continue to be delayed by regulatory incompatibilities and developers will be deterred by concerns that they might not ultimately be able to own and benefit from their projects.

However Ofgem also needs to provide certainty to the industry regarding how this discretion would be applied. Otherwise there is a risk that innovative projects are deterred (as set out above), that the competitive transmission industry is unprepared for a project Ofgem expects them to tender for, or that incumbents failing to raise the capital required as they expect work will go elsewhere).

It is therefore essential that Ofgem provides clear principles and a set of “default arrangements” that can be expected to apply when there are no unusual project-specific circumstances. These should be based on the principles set out in our response to question 8 above.

Question 10: Do you think that the case for change to current arrangements to enable more integration and coordination is material now, or may become so in the future? If the latter, when?

As discussed in our response to question 1 above, the scale of new investment in transmission, the scale of potential benefits from competition (as revealed by the results of OFTO tenders to date) and the benefits of multipurpose projects (as demonstrated by our analysis of the France-Alderney-Britain project) show a strong case for improved co-ordination and increased competition.

As noted elsewhere rapid introduction of new arrangements would not only mean that these benefits are delivered more rapidly, it would also mean that the delays to projects (notably interconnectors) caused by the current uncertainties can be ended.

Question 11: What are your views on our emerging thinking to consider further an enhancement of NGET’s role as the SO in system planning to provide for a more coordinated and holistic approach across the GB system?

Although enhancing the SO's role may indeed "provide for a more coordinated and holistic approach across the GB system" such benefits may be more than offset by the disbenefits that will result if the SO remains closely tied National Grid's onshore TO business and affiliated to National Grid's interconnector business.

We note Ofgem's view that despite an enhanced SO role "full separation of the SO function may not be needed" rather "some steps may be needed to improve transparency of decision-making" – which we assume refers to the production of some additional reports by the SO justifying its decisions. Unfortunately as no other parties have access to the tools and data needed to undertake in-depth system analysis such reports will provide little or no opportunity to challenge the SO's decisions.

Overall we are disappointed that, despite independent academic guidance favouring an independent system operator⁵, Ofgem seems to be considering a substantial increase in the SO's power (including even "support for Ofgem decision making") without comparable increases in its independence.

The special access to Ofgem proposed for the non-independent SO is a notable concern. It seems very unusual to us that a situation would be created where one private-sector player in a competitive market is granted privileged access to the decision making process of the regulator. This does not appear to comply with the norms of good governance.

If the independence of the SO is not increased then there is a significant risk that by increasing its influence and power Ofgem could damage competition and hence increase prices for consumers. New entrants will not wish to invest in transmission if they feel that they face a tilted playing field where a competitor (National Grid) is given special privileges by the authorities.

To avoid this risk there needs to be genuine separation of the SO from the rest of National Grid:

- i) In management terms: we understand that the SO business is not currently a distinct management unit within the NGET reporting structure with its own chief executive, board or policies.
- ii) In personnel terms: there is currently no restriction on a "revolving door" of staff between the parts of National Grid.

⁵ The Imperial College / Cambridge University report notes that "the presence of substantial conflicts of interest: or the perception of those, have been identified at a number of levels. These include conflicts arising from the competitive businesses of the NGET, conflicts due to preferential access to information as well as EMR contract design and transmission planning conflicts. Their existence necessarily alters the incentives of different parties engaged in transmission planning and delivery leading to potential inefficiencies as well as complicating the role of Ofgem and its ability to implement incentive schemes."

- iii) In incentive terms: SO staff and management appear to be incentivised to boost group profitability, which is not consistent with neutrality.

It is our opinion that the current European legal requirements for generator – SO separation should be the minimum required for separation between the SO and other transmission-industry players. We attach these as Annex 2.

Question 12: What are your views on the emerging thinking that introducing further flexibility and applying criteria to designate whether an investment should be delivered by incumbent delivery or competitive selection could address many of the challenges and drivers identified?

As noted previously, we generally favour introducing flexibility but only where it brings competition to areas previously under monopoly ownership.

Question 13: What other options should we take forward for consideration in the next stage of our work on ITPR?

We believe that the option of business separation arrangements for the SO based on the requirements of European legislation for generator – transmission separation should be taken forward. We describe this option further in Annex 2.

Question 14: Do you have any views on our approach and timetable for our work on ITPR, or on interactions with related areas?

As noted in the text of our letter above, there is an urgent need for provide increased certainty to the developers of interconnector projects. This suggests that the ITPR project needs to examine how to accelerate its proposed timescales in this respect at least. The text of our letter sets out how this could be achieved in the case of interconnection policy.

Question 15: Do you have any other views on the ITPR project not covered by these questions?

No.

ANNEX 2

SEPERATION OF SYSTEM OPERATOR

The table below sets out the degree of management separation required between an SO business and competitive generation businesses by EU direction 2009/72. Transmission Investment believes that this is the minimum that should be required for the analogous separation between an SO business and competitive transmission businesses (including incumbent TOs facing the introduction of competition).

The table also shows how poorly this level of separation compares with that currently in place between the SO and National Grid Offshore (i.e. National Grid's OFTO business). Even less separation exists between the SO and other National Grid businesses.

	NGET C2 Compliance Statement	Directive 2009/72 ITO model (Articles 17 - 22)	Implication for SO separation of applying rules analogous to 2009/72
General	"Maintain appropriate managerial and operational independence". No definition of what level of separation is "appropriate" – self certified by an NGET director	"The [monopoly] transmission system operator shall have ... effective decision-making rights, independent from the vertically integrated undertaking" (Art 18,1)	SO to have its own independent decision- making rights.
Data processing and storage	"policies in place to ensure that no access [to NGET data] is granted to employees of [NG Offshore]". Implies that the same systems are used, with separation through password access policies, etc.	The transmission system operator shall not share IT systems or equipment ... with any part of the vertically integrated undertaking nor use the same consultants or external contractors for IT systems or equipment. (Art 17,5)	Separate IT systems
Management separation	Both NGET and NG Offshore report to Executive Director, UK (one level below Group CEO).	Supervisory body with independent, regulator-approved members ensures management separation of monopoly-TSO (Art 20). This supervisory body is responsible for personnel appointments within the monopoly-TSO (Art 19, 1), not the parent company.	Separate SO board with independent members appointed by Ofgem. SO executives are appointed by, and report to, this boards

Compliance Officer	Compliance officer is NGET staff member, reporting to the UK General Counsel (part of the legal department, a shared service used by NGET and National Grid Offshore).	Compliance officer is appointed by supervisory body (which has independent outside members). Appointment must be approved by regulatory authority.(Art 21)	Compliance officer appointed by independent SO board
Services provided by NGET to NG Offshore	Arms lengths basis, as defined and monitored by shared-services compliance officer.	Any agreements to provide services must be approved by the national regulatory authority, Art 17(c)(ii) and Art 18,7	SO cannot subcontract to other parts of National Grid without Ofgem approval.
Shared services (for NG Offshore this includes Regulation department, Insurance, Legal)	"Individual employees and agents of NG shared services will not concurrently serve both NGET and [NG Offshore]"	Shared service organisations within the group are not allowed – monopoly TSO cannot receive services from other parts of vertically integrated undertaking (Art 17,1(c)).	No departments providing shared services to SO and other parts of National Grid (in contrast to current situation where, for instance, the Regulation department is shared)
Transfer of employees	" NGET will manage the transfer of employees [to avoid information leaking]". Each case considered individually by the (shared-service legal department) compliance officer. "A transitional time period appropriate to the circumstances will be agreed by the [compliance officer] on a case by case basis." No guidance given as to what may be appropriate – whole responsibility is given to the compliance officer.	6 month - 3 year gap before senior staff can transfer to monopoly-TSO arm (Art 19). 4 year gap before senior staff from monopoly-TSO can transfer to competitive activities. (Art 19, 7)	Delay is SO executives moving to other parts of National Grid and vice versa to avoid "revolving door"
Auditing	No restrictions	The accounts of transmission system operators shall be audited by an auditor other than the one auditing the vertically integrated undertaking or any part thereof.	SO should have a different auditor to National Grid group
Bonuses, etc	No restrictions	Remuneration, bonus, shares, etc, of monopoly-TSO staff must not be linked to success of other (competitive) activities within the group. (Art 19,5)	Remuneration, bonus, shares, etc, of SO executives and staff must not be linked to profits/shares of National Grid group

