

Offshore Transmission Licensees,
Network Operators, Generators,
Investors, Consumer Groups and
other interested parties



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for energy consumers

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Date: 19 September 2014

Dear Stakeholder,

Conclusions of Consultation on the Evaluation of OFTO Tender Round 1 Benefits

On 13 May 2014 Ofgem began a consultation on a report from independent consultants CEPA and BDO¹. The report assessed the outcomes of the benefits that Offshore Transmission Owner ("OFTO") Tender Round One ("TR1") created. The consultation closed on 4 August 2014 and this letter sets out the conclusions we have reached.

CEPA/BDO's report estimates that in TR1, with a total lifetime OFTO income of £1.5bn, Ofgem's competitive tendering of offshore transmission assets has saved consumers between £200m and £400m relative to various possible scenarios. The main reasons for the savings are:

- relative to the price control based solutions, competition leading to the adoption of more efficient operating strategies and the revelation of efficient costs; and
- relative to merchant solutions, more efficient allocation of risks leading to lower market pricing of such risks.

CEPA/BDO also estimate that if the same cost benefit analysis methodology used to evaluate the TR1 projects were to be applied to projects in Tender Round Two ("TR2"), the additional cost savings could be considerable. For example, the cost savings (as a percentage of asset value) for London Array (the first project in TR2 to have reached financial close) could be 20-30% higher than for the TR1 projects.

Responses to consultation

During the consultation period, a workshop was held where the report was presented by CEPA to stakeholders. This provided an opportunity for stakeholders to ask questions and provide feedback. Stakeholders attending the workshop were broadly supportive of the analysis undertaken and the conclusions reached. Whilst a number of points were made these mainly related to the OFTO regime as a whole and were not confined to the content of the report which was understood and supported by the meeting.

¹ Evaluation of OFTO Tender Round 1 Benefits – Report by CEPA & BDO
<https://www.ofgem.gov.uk/ofgem-publications/87717/cepabdtr1benefitsassessmentfinalreport.pdf>

We received one written response on the CEPA/BDO report, from National Grid Electricity Transmission ("NGET")². NGET accepted that the OFTO regime had attracted new sources of finance and identified operating costs closer to the efficiency frontier faster than would have occurred had any of the counterfactuals been implemented. Besides expressing broad support for the review NGET made a number of specific points relating to the analysis of the TR1 cost savings and wider comments on future implications. We consider these points below before drawing our conclusions.

NGET's specific comments on the analysis of the TR1 cost savings

NGET raised questions and gave views on the assessed savings in operational expenditure, the calculation and interpretation of tax benefits, and risks to consumers.

In relation to operational expenditure benefits relative to the merchant approaches, NGET had some difficulty in understanding the assessment made by CEPA/BDO. More specifically, it did not see clear evidence presented in the report as to why generators undertaking maintenance services to their own assets would result in higher overall costs for consumers than if they were to provide these services to third party OFTOs.

Winning bids in TR1 did not always involve maintenance being supplied by generators. Successful bidders in TR1 adopted innovative maintenance strategies which were, on balance, below the average prices being put forward including those proposed by the generators themselves. CEPA/BDO assume that the merchant counterfactuals would also make use of the competitive market including maintenance services provided by generators. However, for the full range of operating costs, these counterfactuals would not replicate all the benefits of the open competitive process of the OFTO tendering regime coupled with the transparent regulatory process to attract new service providers and innovative strategies. In their assessment, CEPA/BDO take average bid prices as an estimate of the operational expenditure which would have been incurred by the merchant counterfactuals.

In relation to tax benefits, NGET questioned how these were calculated and if the ultimate impact from a social welfare perspective may be offset by potential additional burden for taxpayers.

As explained in their report, CEPA/BDO's tax calculations for all counterfactuals are based on similar principles to those Ofgem adopts for setting tax allowances in onshore network price controls. Establishing the social benefit that arises from a tax saving is a complex issue. It is not Ofgem's role to speculate on the Government's response to lower tax revenues, rather we have sought to concentrate on the authors' identification of savings exclusive of tax and it is these that we present in our conclusions.

In relation to risks to consumers, NGET considers that CEPA/BDO have not identified the extent to which risks associated with managing these assets under the OFTO regime has been shifted to consumers compared to under the model of assets being built by an onshore transmission owner.

Under TR1, all offshore transmission assets are built by the generators, and so the counterfactuals based on onshore price controls only differ from the OFTO regime in how the owners of these assets are appointed and how they are subsequently regulated. The OFTOs appointed through competitive tenders are subject to robust regulatory requirements, such as performance targets associated with financial penalties and rewards, and reporting requirements for regulatory monitoring. This is of the same rigour as price control based regulation onshore. As such, we do not see additional risks being shifted to consumers.

² The NGET response is published along with this letter

NGET's wider comments on future implications

NGET commented on potential savings in future tender rounds and the effectiveness of the OFTO regime to address future network development needs such as the coordination of onshore and offshore transmission networks.

In relation to savings in future tender rounds, NGET considered that, as the efficient cost frontier has been revealed, some of the savings in TR1 are one-off in nature, may diminish in future rounds, and may even be outweighed by bid costs.

CEPA/BDO assume in their report that price control mechanisms tend to set allowed revenues at levels which approach efficient cost frontiers. This is achieved through either a sequence of steps in successive price controls, or even by progressive reductions within a price control. Their calculation is based on the assumption that towards the later part of the lifetime of the assets, the two regimes would reach broadly comparable operational costs. We will of course keep under review how the revelation of the efficient cost frontier influences future tender rounds and indeed how it informs future price controls. We note further that the expected downward trajectory of costs could be disturbed by variations in the characteristics or operational environment of the assets and that competition would be more likely to reveal further efficient cost reductions sooner.

In relation to the future network development needs, NGET commented on the need for flexibility in the use of offshore assets in an integrated energy network. It believes that when considering such needs in the long term, it is a more complex assessment as to whether the current OFTO regime would offer the best solutions or contain sufficient flexibility. However, it indicated continued support for Ofgem's review and ongoing development of the regulatory arrangements under the Integrated Transmission Planning and Regulation (ITPR) project.

We are fully aware of the future challenges and indeed have been leading the ITPR project to develop a fit-for-purpose regulatory approach. We welcome NGET's commitment to support this work.

Conclusions

Based on feedback received at the workshop and in written responses, we believe that CEPA/BDO have provided a robust methodology and analysis for assessing cost savings achieved by the OFTO regime in TR1 as being in the range £200m to £400m.

We also note CEPA/BDO's analysis indicating even greater potential savings in TR2 projects. We are committed to ongoing evaluation of the OFTO regime and will continue to undertake assessments to establish whether further savings can be identified, taking into account new developments and evidence.

Yours faithfully

Min Zhu
Associate Director of Offshore Transmission