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for energy consumers

All interested parties

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Dear colleagues

Criteria for onshore transmission competitive tendering

We recently announced that we will introduce competitive tendering to deliver new, separable and high value onshore electricity transmission assets.[1] The purpose of this letter is to set out and seek your views on what considerations we should take into account when defining and applying the new, separable and high value criteria. We welcome your views, in particular on the questions set out at the end of this letter, by 10 July 2015.

Context

The RIIO-T1 price control for onshore transmission owners (TOs) set out that strategic wider works (SWW) projects could be subject to third party delivery where it is in the interests of consumers to do so.[2] Our Integrated Transmission Planning and Regulation (ITPR) project then considered and consulted on where competitive tendering could drive value for consumers. ITPR concluded that tendering new, separable and high value transmission investments could bring consumer benefits such as cost savings and innovation.[3] Even though onshore tendering will be limited to SWW projects during RIIO-T1, for RIIO-T2 we will consider applying tendering to non-SWW onshore assets, such as generator connections, if they are new, separable and high value.

We are now developing the criteria so that they can be applied to proposed transmission investments. Our current views on each criterion are below, followed by a discussion on ways to apply them. Jacobs, an engineering firm, has given us technical support and engaged stakeholders in its work. We have published Jacobs' report alongside this letter.

We want to establish clear, consistent criteria that provide confidence for stakeholders. We will take your views on this letter into account and intend to consult on a preferred position in the autumn. Over the longer term, we intend to keep the criteria under review. They could be amended from time to time, following consultation, if doing so means providing better value for consumers.

Our planned autumn consultation will also include proposals for the commercial and regulatory construct for onshore competition, including the tender models and the

[1] https://www.ofgem.gov.uk/publications-and-updates/integrated-transmission-planning-and-regulation-itpr-project-final-conclusions
[2] For NGET RIIO-T1 final proposals, see https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf, p9 and for SPT and SHE-T RIIO-T1 final proposals, see https://www.ofgem.gov.uk/ofgem-publications/53747/sptshetlfpsupport.pdf p15.
[3] For more detail on the potential costs and benefits of competitive tendering, see the ITPR impact assessment https://www.ofgem.gov.uk/ofgem-publications/93913/itprfinalconclusionsimpactassessmentpublicationfinal-pdf.

incentives and obligations for incumbent TOs, the system operator (SO) and competitively appointed TOs (CATOs). In the meantime, we continue to work with government on legislative change to support competitive tendering for onshore transmission. We aim to be in a position to run the first tender in 2016 or 2017.

We are examining which RIIO-T1 SWW projects may be suitable for tendering in line with the criteria. We recognise that, in addition to considering whether these projects meet the criteria, we will also need to consider the effects of tendering projects where incumbent TOs have already undertaken significant pre-construction work. We intend to discuss this further with TOs over the coming months. We anticipate providing more certainty on the tendering pipeline once the detailed arrangements, including the criteria, are further developed. We will decide if we will tender specific RIIO-T1 SWW projects after considering their needs cases.

Defining high value

We are seeking your views on setting £100m in capital expenditure (capex) as the minimum value for an onshore transmission project to be tendered.[4] We do not think there should be a maximum value for tendering. A £100m threshold would mean that we tender assets where the potential benefits from cost savings and innovation will significantly outweigh the potential administrative and interface costs. We also think that tenders for projects valued at or above £100m are likely to attract significant market interest.

Tendering projects that are valued lower than £100m could also attract bidders and lead to benefits. For example, we successfully tendered offshore transmission assets with values below £100m in tender round 1. But by setting the threshold at £100m, at least initially, we would create additional confidence that there will be savings from tendering. In response to our ITPR draft conclusions consultation, some stakeholders thought a £50m-£100m range was about right, while others thought the threshold should be at least £100m.

Estimating capex should be relatively simple and straightforward. Such simplicity could be beneficial for the purposes of quickly and transparently identifying whether projects exceed the high value threshold. While it does not cover all costs, capex could be an appropriate proxy for the relative overall costs.

As noted by Jacobs in their report, we could also consider using a whole life approach to estimating costs, which would add other aspects of project costs, such as operation and decommissioning costs to the estimated capex in determining the overall project value.[5] A whole life approach provides a more complete picture of the overall project costs. Many stakeholders who participated in Jacobs' work thought that a whole life approach would be more appropriate. However, since future costs (such as decommissioning) are relatively less certain, a whole life approach could lead to greater difficulty in agreeing appropriate estimates, particularly for projects that are near the threshold.

We discuss in the 'applying the criteria' section below how we could assess high value, including our scrutiny of the process and how projects near the threshold might be treated.

Defining new and separable

Tendering assets that are new means that we can more easily maintain regulatory continuity and clarity for existing asset owners, which is important for achieving long term stability and therefore value for consumers. It also means that new entrants avoid risks inherent in taking over assets that have been operational for some time.

[4] This is only for the purposes of determining whether the project meets the high value threshold for tendering. We anticipate CATOs will be competitively selected to construct, own and operate transmission assets over a defined revenue period.

[5] Jacobs suggests that whole life costs would typically be 5-20% higher than capex costs, so if using a whole life approach, a threshold higher than £100m may be appropriate.

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Separable assets can be scoped for tendering more easily and efficiently. Tendering separable assets also minimises interface complexities between existing asset owners (eg TOs and distribution network operators (DNOs)) and new entrants, both during construction and operation.

Feedback from stakeholders as part of Jacobs' work indicated that it is difficult to treat new and separable as individual concepts because the factors that need considering can overlap significantly. Below, we consider new and separable together.

Basic principles

At a basic level, we think that for an investment to be considered new and separable it should include construction of transmission assets where:

- transmission assets don't currently exist (ie 'greenfield'), or where new transmission assets will completely replace existing ones; and
- ownership boundaries can be clearly delineated in industry codes and standards, so that it is clear who is responsible for each asset.[6]

New and separable assets therefore would include one or more of:

- a greenfield overhead line, cable, or substation; or
- a complete replacement of an existing overhead line, cable, or substation.

Tendering projects that meet these parameters would mean that tendering is used for relatively straightforward and discrete transmission projects. This has advantages in minimising the overall complexity of delivery by the CATO, and therefore reduces costs and maximises the benefits to consumers from tendering.

We also think any interpretation of the above principles should take account of the practicalities of how transmission assets are designed and built. We therefore think that interpreting these principles should not:

i. Preclude competitive tendering where projects re-use land and route corridors, but where the electrical equipment[7] would be newly manufactured and installed. This is because land and route corridors for infrastructure are often well established and transferring it carries relatively little risk to either party.

ii. Preclude competitive tendering of projects where works are required to modify or upgrade other existing transmission assets, where these works are undertaken for the purpose of connecting the new/replacement overhead line, cable, or substation to the national electricity transmission system (NETS). For example, we would not preclude a project from tendering just because an incumbent TO undertakes works on its own assets as a result of the CATO's assets connecting in. This is because almost any transmission project will require this, and it is well established through existing TO-TO, TO-generator, and TO-DNO interfaces that the interactions between parties can be effectively managed.

Additional/alternative considerations

Jacobs highlights in its report additional factors to take into account when considering the definitions of new and separable. We briefly discuss these points below.

[6] The CUSC 'Principles of Ownership' define boundaries between TOs and users, and TOs and DNOs. These principles could be adapted to also apply to TO-TO boundaries.
[7] For example, the National Electricity Transmission System Security and Quality of Supply Standard, Version 2.2 defines Primary Transmission Equipment as "Any equipment installed on the national electricity transmission system to enable bulk transfer of power. This will include transmission circuits, busbars, and switchgear".

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The Jacobs report suggests that whether all aspects of a project are directly and physically connected to one another (electrical contiguity) should not be a prerequisite for the new and separable criteria, and we agree. Jacobs' report also notes that increased electrical contiguity could have some benefits in terms of minimising the costs and complexity of managing interfaces. We think this should be considered when works are initially packaged together, as discussed in the next section.

We also agree with Jacobs that electrical separability (the use of a circuit breaker at each interface) should not be a prerequisite for the new and separable criteria. However, Jacobs' report suggests that electrical separability could provide benefits to asset operation and, if it's not included in the initial design, it should be added to a tendered project if the cost of doing so would be less than 5% of the overall project cost.

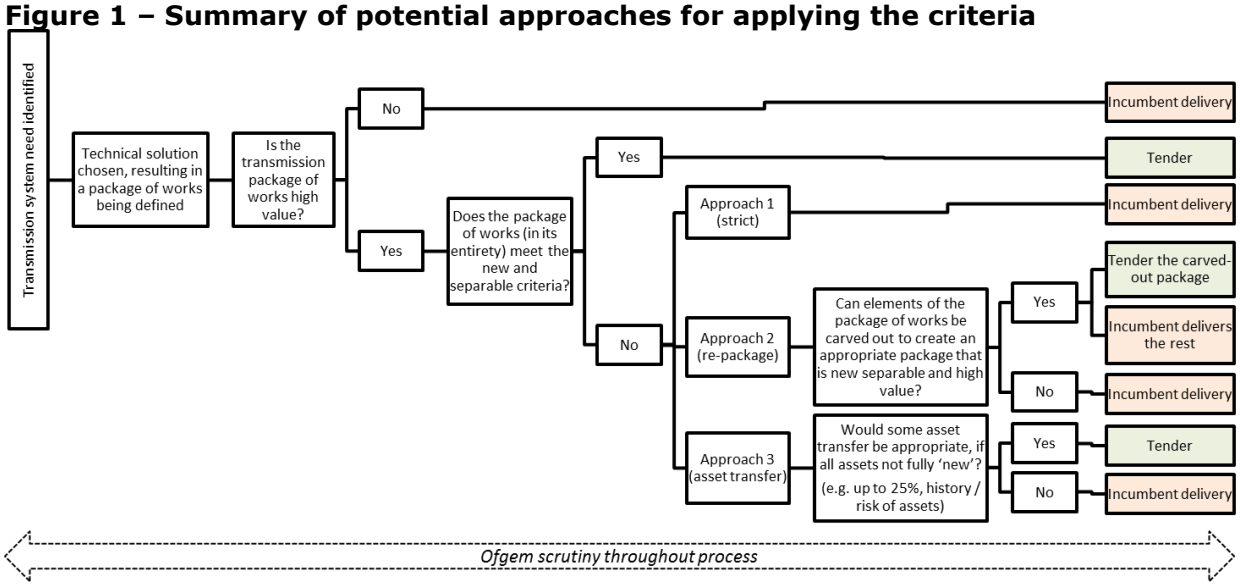
We think it is important that a project can clearly be defined and that there are clear ownership and control boundaries between interfacing parties. However, adding electrical equipment may not be in the interests of consumers if it is not required to achieve the benefits of competition. An alternative approach to Jacobs' 5% threshold would be to enable a CATO, where it wished to have the extra control over its assets that electrical separability would provide, to propose this as part of the tender process. In doing so, CATOs would take into account the likely costs and benefits of electrical separability.

Jacobs' report also addresses the degree to which a project could 'substantially' but not completely meet the principles of new and separable outlined above. Jacobs suggests that if up to 25% (by cost) of a project is made up of works that aren't new, tendering the project could still deliver consumer value. Under such circumstances, some existing assets might need to be transferred to the successful bidder so that the project can be effectively scoped and managed. According to Jacobs, the transfer of existing assets below a 25% threshold could be managed effectively between the TO and the CATO, but that factors such as the age and condition of the existing assets would also need to be considered. We consider how to address this in the next section.

Applying the criteria

The ultimate outcome of using the criteria will be influenced by how they are applied. We think that there are alternative approaches for doing so, outlined in Figure 1 below.

Figure 1 – Summary of potential approaches for applying the criteria



We haven't set out the detail of who will be responsible for each step since we think it is important to establish the key steps first. However, as set out in our ITPR final conclusions, we will be responsible for deciding whether a project meets the criteria for tendering. We

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envisage providing further detail on roles and responsibilities, and how the criteria interact with existing system planning processes, in our autumn consultation.

What to apply the criteria to?

Under all approaches, a need on the transmission system would be identified, with a technical solution chosen. That technical solution would be assembled into a package of works, or multiple packages of works, for development and construction. We envisage that the package of works would be put together using the same considerations that delivery parties currently use. For example, when planning network upgrades or new infrastructure, incumbent TOs take into account the timing of the need, the anticipated timescales for delivery, the location(s) of the works, and the relationship between the new works and the existing network. They use this to group works into appropriate packages that are efficient to deliver together. This process also takes into account the extent of electrical separability in a project, as well as what electrically non-contiguous assets, if any, to take forward together.

We consider that many of these initial steps would occur using existing or planned processes, such as the Electricity Ten Year Statement (ETYS), the new Network Options Assessment (NOA) that is currently being implemented, or other network planning processes like the connections process for generators. We envisage that these processes would be adapted in the future as necessary to integrate the use of tendering for onshore transmission.

Some stakeholders have raised concerns that projects could be deliberately assembled to avoid being tendered. We think that open and transparent consultation on the ETYS and NOA will enable stakeholders to engage in system planning processes and to flag any such concerns. We will also have scrutiny of these initial steps as well as the potential assessment processes described below to ensure consumers' interests are protected.

Assessment process

A package of works would first be assessed against the high value threshold. If the threshold is not met, tendering would not be considered further. In practice, we could seek to examine projects that were near the threshold (for example, between £75m and £100m) to ensure that costs had been appropriately estimated.

If the project is high value, it would be assessed against the new and separable criteria. A project that is also clearly new and separable, based on the criteria, would be tendered. However, if it is not new and separable, we think there are three approaches worth considering. The approaches outlined here are not necessarily mutually exclusive, and elements from Approaches 2 and 3 could potentially be combined.

One approach (Approach 1) would be a 'strict' application of the new and separable criteria. Here, if a project doesn't initially meet all aspects of the new and separable criteria, it wouldn't be tendered. Such an approach could be straightforward and transparent, but it might also be too restrictive and not take into account alternative ways to deliver the works.

An alternative approach (Approach 2) would be to re-examine the package of works to see if there are elements that could be identified as new, separable and high value, and appropriately carved out for tendering. For example, if a project contained some overhead line upgrades, as well as a new subsea cable and a new substation, the cable and substation could potentially be carved-out to form a new, separable and high value project. As with the initial scoping, this would only be done if there was an appropriate package that takes into account overall deliverability. The works that met the criteria would be tendered, and the remainder would be taken forward by the incumbent TO.

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The main benefit of this approach is that it maintains the relative simplicity and transparency of applying the criteria, while taking account of stakeholder concerns to ensure that appropriate packages are tendered, in consumers' interests. However, it could add more time and complexity than Approach 1.

A third potential approach (Approach 3) would be to view packages of works as 'substantially' rather than completely new. This would align with Jacobs' view in its report that in some circumstances transferring assets as part of the tender could be managed without creating undue costs and risk, as the OFTO regime to date demonstrates. We envisage that if this were to occur, we would regulate the asset transfer, and we would need to establish guidelines for what could be considered for asset transfer. Jacobs suggests that the existing assets would need to be at most 25% of the overall project cost, and that the specific risks associated with the assets, such as age, maintenance and operational history, would need to be considered before deciding to transfer them.

The third approach would recognise that there are some instances where asset transfer could be justified and manageable, and therefore would ensure that the criteria don't rule out the benefits that could be achieved from tendering projects that are substantially but not wholly new. However, it does carry additional subjectivity, and transferring assets that have been in use for some time could result in risk and complexity.

Feedback requested

We seek your written feedback on the content of this letter, in particular on the following questions. The closing date is 10 July 2015. Please send written responses by email to Pete Wightman at TransmissionCompetition@ofgem.gov.uk. We are also open to meeting you in the interim to discuss your views.

1. What are your views on the analysis and conclusions in Jacobs' report?

2. What are your views on using £100m as the high value threshold? Should this be whole life or capex?

3. What are your views on defining new and separable? Are our principles clear? In your view, do they appropriately capture projects where using competitive tendering would bring value to consumers? If not please explain and suggest how we can improve them.

4. What are your views on the importance of electrical separability and electrical contiguity, including on the alternative approaches for considering electrical separability?

5. In thinking about how to apply the criteria, what should be taken into account when establishing different packages of works to address a given need?

6. What are your views on the three approaches we suggest for applying the criteria? Are there other options for applying the criteria that we should consider?

7. Are there any additional considerations that should be taken into account in relation to the new, separable and high value criteria?

Yours faithfully,

Cathryn Scott
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