

Extending competition in electricity transmission: summary of responses to our October 2015 consultation

Summary of responses to our October 2015 consultation – Supporting Document

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Overview:

In this document we set out a summary of stakeholder responses to our consultation “Extending competition in electricity transmission: arrangements to introduce onshore tenders”, published in October 2015.

We have set out in our main consultation how the views, in relation to the criteria for competitive tendering and their application, and the management of conflicts of interest have been considered and incorporated into our policy development.

We intend to publish further details on our proposals for the tender models and market offering for competitively appointed transmission owners for consultation within the next few months. We will identify in that document how views provided in relation to these areas have been considered and incorporated into our policy development.

We have published all non-confidential responses received to our consultation on our website.

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1. Introduction and overarching responses

1.1. Our October 2015 consultation (October consultation) provided details on our proposed arrangements for introducing competitive tendering for new, separable and high value transmission assets onshore. We requested stakeholder views on our proposals relating to the criteria for competitive tendering onshore and their application, the running of competitive tenders, the regulation of competitively appointed transmission owners (CATOs) and how conflicts of interests will be managed.

1.2. We received 35 non-confidential responses to the consultation which have all been published on our website. These responses came from a wide range of stakeholders including electricity network operators, investors, generators, supply chain contractors and industry bodies, and a number of bodies involved in the environmental aspects of electricity transmission, particularly during the consenting process.

1.3. We also received some additional responses to aspects of the consultation, provided on a confidential basis. These confidential responses have informed our analysis and are summarised within this document, where it is possible to do so without compromising their confidentiality.

Overarching responses on competitively tendering onshore transmission

1.4. Respondents were broadly supportive of our objectives in running competitively tenders for licences regulating onshore transmission assets. However, some respondents challenged our assessment of the benefits of competitive tendering onshore, as published in March 2015.¹ In line with good practice, we have updated our impact assessment to reflect our most recent understanding of the impacts, having regard to the analysis provided in the consultation responses, new evidence provided and our more detailed policy development. Our analysis continues to show there are considerable benefits to consumers from extending competition onshore.

¹ Integrated Transmission Planning and Regulation (ITPR) project: Final Conclusions – Impact Assessment, Supporting Document, 2015
https://www.ofgem.gov.uk/sites/default/files/docs/2015/03/itpr_final_conclusions_impact_assessment_publication_final.pdf

Counterfactual against which competition is compared

1.5. Some respondents considered that our assessment of the benefits of extending competition onshore are in fact due to the potential benefits of a project finance approach, enabling the use of higher gearing ratios, and the introduction of a 25 year revenue stream, compared with portfolio approach taken by the incumbent transmission owners (TOs). They note that the incumbent TOs regulatory asset bases (RAB) are the result of multiple financing arrangements for different assets and encompass debt of different ages. They considered that similar approaches could be used by the incumbent TOs if their licences were amended to enable higher gearing to be used for specific major investment projects, which could result in savings. We have considered the points raised by respondents when developing our updated impact assessment and we have provided further information in that document about our reasons for assuming the counterfactual we have used.

Evidence of cost savings

1.6. Some respondents commented on our assessment of the benefits of introducing competition to onshore transmission in our March 2015 impact assessment. Some considered that the benefits need to be more clearly defined and should also consider longer term, whole system benefits, costs and risks likely to materialise over the lifetime of transmission projects. They consider this is necessary to define what a successful onshore competitive regime should be. One respondent considered that to be successful onshore tendering should also enable wider market participation and accelerate the processes of investment and connections. We have updated our assessment of the benefits of onshore competition in our impact assessment using the updated evaluation of the offshore regime and drawing from further evidence internationally. However, many of these benefits are hard to quantify. We have drawn on quantitative assessments of comparable competitive regimes as an illustration, but do not make our own quantitative assessment. Our updated impact assessment provides further information.

1.7. Several respondents considered that there may be additional costs of introducing competition into onshore transmission which our March 2015 impact assessment had not accounted for. These included increased interface costs due to the introduction of more network parties, costs of potential delays to CATO delivery dates, transactional and bidding costs, and an increased regulatory burden for us due to the increase in the number of licensees. Some respondents stated that our assessment of costs and impacts should extend beyond those experienced by consumers to include those experienced by generators, other network owners and community groups.

1.8. Some respondents also considered that the potential cost savings from competition may be limited as TOs already undertake competitive procurement processes and members of the supply chain may seek to recover their costs of engaging with multiple bidders by raising their costs.

1.9. We have reviewed and refined the costs we included in our impact assessment in the light of these consultation responses and provide further information about our reasons for including specific sources of costs. We still conclude that there will be considerable benefits to consumers from extending competition onshore. Our updated impact assessment provides further details.

Comparison with offshore transmission regime

1.10. Some respondents considered that our assessment of the benefits of tendering relied heavily on the savings² achieved in tenders for offshore transmission licences. Respondents noted that there are a number of differences between the offshore regime and onshore competition including; the interconnected nature of the onshore network, the varying degrees of criticality of assets across the wider transmission network, the potential for further development of assets if extensions or new customer connections are required, the different risk and investment profiles as in offshore tenders to date bidders have not needed to account for construction risk, and the potential for a large asset transfer risk at the end of the onshore revenue term.

1.11. One respondent noted that some of the financing benefits which have been realised in the offshore regime tenders to date were due to the timing at which these investments were made, which has allowed them to benefit from a low cost of debt. In developing our updated impact assessment we have considered this response and also drawn on independent analysis by CEPA³ which analysed the cost savings achieved by OFTOs. CEPA's analysis concluded that the savings from the OFTO regime are partly due to a reduction in underlying wholesale finance market rates between 2010 and 2015, but also due to improvements in debt financing terms that the OFTOs have been able to negotiate, benefits OFTOs can receive from inflation linked financing and lower rates of return required by equity providers working in the sector.

1.12. We recognise the differences between the onshore and offshore regimes highlighted by respondents and do not make like-for-like comparisons. Nevertheless, the offshore regime presents a very useful (and obvious) point of comparison and we expect competition will drive efficiencies and cost savings over current onshore arrangements in a similar way. The offshore regime is therefore a good indicator of the potential of competition onshore.

² Evaluation of OFTO Tender Round 1 Benefits, 2014
<https://www.ofgem.gov.uk/publications-and-updates/consultation-cepabdo-evaluation-offshore-transmission-tender-round-1-benefits>

³ Evaluation of OFTO tender round 2 and 3 benefits, 2016
<https://www.ofgem.gov.uk/publications-and-updates/evaluation-of-to-tender-round-2-and-3-benefits>

Cost benchmarking

1.13. The Scottish Government acknowledged the potential of onshore competition to bring greater transparency to information on costs, which may provide further regulatory benchmarks, and in turn help support our scrutiny of costs. We agree that the involvement of new parties enables us to increase the number of data sources we can use to benchmark the cost submissions of TOs and other transmission developers. We also recognise the need to continue to look at project-specific factors when assessing cost submissions.

Potential to lengthen delivery timescales

1.14. Several respondents suggested that running competitive tenders onshore could potentially delay the delivery dates of projects, particularly SWW projects being developed during the RIIO-T1 period by the incumbent TOs. Respondents noted the risk to generation or other linked and dependent network projects caused by delay and the ability of the CATO to mitigate and manage the consequences of delays. We note respondents' views about the potential for delays and have provided more detail about the process we will apply to identifying suitable cases for competitive tendering during the RIIO-T1 period in our main document.

1.15. Some respondents noted that the tender processes may add delays to the delivery of transmission assets, by inserting additional sequential steps and interfaces into the development process. We expect a tender process can be run in parallel with the project development processes, rather than for these to happen sequentially as some respondents have stated. We provide more detail about the pre-tender process in our main document and plan to provide more information on the tender models for consultation in the summer.

1.16. Some respondents stated that there may be an indirect cost if investors in generation projects perceive an increased risk associated with the introduction of competition which may impact their cost of capital. They noted that this may reduce the potential savings to consumers if generation becomes more expensive to finance. In our updated impact assessment we have given further consideration to the potential for delay to a project and appropriate mitigations for this.

Consenting and environmental impacts

Planning & consenting differences in Scotland

1.17. Some respondents considered that the proposals within the consultation for obtaining planning consent for the late CATO build model do not adequately account for the difference in planning law between Scotland and England and Wales. They stated that processes required under Scottish planning law, such as the stakeholder engagement processes, could cause delays to Scottish projects and noted there may be difficulties associated with the transfer of some consents if obtained by a TO or system operator (SO) on behalf of a CATO.

1.18. We note stakeholders' comments about the differences in the planning regimes in England and Wales and Scotland and are working with DECC, the Scottish Government and other stakeholders to resolve any issues that may exist regarding the transfer of preliminary works. We plan to say more about the interaction between the processes we will put in place to appoint CATOs and planning in our summer consultation when we discuss tender models in more detail.

Landscape, visual impact, environmental impacts and wider social issues

1.19. Some respondents commented on the approach CATOs may take to managing and mitigating environmental impacts, landscape visual impacts and other impacts on communities. They noted that evaluating bidders' capability and approach in these regards will form an important part of the tender process. They also noted that this will be an area of CATO performance that we will need to monitor following the grant of a licence and suggested measures such as a performance bond may be appropriate.

1.20. We understand that the planning consent process places important obligations on project developers and we would expect CATOs to comply with any such requirements. We will develop a robust tender process that selects appropriately qualified parties who will be able to take on the responsibilities and obligations of being a CATO, including those relating to managing environmental and other impacts. However, we also note respondents' comments about the role of CATOs in the long-term working with communities and stakeholders to manage visual impact. We are considering the appropriate obligations and incentives that should be placed on CATOs and will say more in our summer consultation.

2. Responses to our proposals on the criteria for competitive tendering and their application

2.1. Our main document provides further detail on our decision on the definitions of the criteria for determining what is tendered (subject to legislative change) and the process for identifying future projects. It also outlines our further proposals on the pre-tender arrangements. In developing these we have considered the consultation responses and the main document highlights how we propose to respond to particular points raised.

Responses to our proposals on the criteria for competitive tendering and their application

Question 1: What are your views on the proposed detailed interpretations of new, separable and high value (the 'criteria')?

Question 2: Under what circumstances do you think asset transfer from an existing asset owner to a CATO would be required, recognising the principle that projects identified for tendering should be new?

Question 3: What are your views on our proposal that electrical separability should not be required at each interface, but that the SO can propose it to us if it thinks there is a cost-benefit justification based on system operability?

New and separable

2.2. The majority of respondents supported our proposal that assets which are brand new or which are a complete replacement of an existing asset and for which ownership boundaries can be clearly delineated, should meet the new and separable criteria for tendering.

2.3. Several respondents considered that there may be cases where some assets may need to transfer to a CATO from an incumbent asset owner; however we should look to minimise the assets and instances where this is required. Respondents noted that for most projects such a transfer will be limited to assets which are necessary for the CATO to develop its project efficiently, such as preliminary works, consents or land rights. Some respondents noted that transfer of these assets could cause delays to the tender process, particularly for projects in Scotland, where the planning regime differs from that in England and Wales. As noted in paragraph 1.18 we are working with DECC, the Scottish Government and other stakeholders to resolve any issues regarding the transfer of preliminary works.

2.4. A few respondents suggested that if a project requires existing assets to be decommissioned and replaced we should consider on a case by case basis which party is best placed to undertake the decommissioning work. Respondents noted that in such cases there will be clear need to allow bidders time to undertake due diligence on the asset condition and the importance of our involvement to determine the value of any assets to be transferred.

2.5. The majority of respondents supported the proposal that electrical separability should not be required in order for projects to satisfy the separable criteria for tendering. Although some respondents had a preference for this they acknowledged that existing arrangements are already in place to make ownership boundaries and responsibilities clear at interfaces. The majority of respondents were also supportive of the proposal that electrical separability may be proposed for projects if the SO considered there is a cost benefit justification for its inclusion.

High value

2.6. Respondents' views on the high value threshold of £100m were mixed. The majority of respondents supported this threshold and considered £100m an appropriate minimum threshold to attract investment and ensure that the benefits outweigh the costs of tendering for both consumers and bidders. Some respondents suggested that there may be benefits in tendering projects below £100m once the regime has become established. A few respondents highlighted the benefit of a clear pipeline of projects and the use of tender rounds in attracting sustained market interest.

2.7. Two respondents considered that the £100m threshold is too low and that a higher value threshold should be used to ensure the benefits of tendering are greater than the costs. They both considered that costs will be higher than estimated in our ITPR March 2015 impact assessment.

2.8. Four respondents (Scottish Hydro Electric Transmission (SHET), Scottish Power Transmission (SPT), the Scottish Government and the Highlands and Island Enterprise) do not support some of our proposals in relation to the application of the high value threshold during the RIIO-T1 period. They consider that as a consequence of the different SWW value thresholds for the three incumbent TOs, Scottish TOs would be exposed to more competition than the English and Welsh TO; missing opportunities for savings from competition for English and Welsh consumers. They suggest it would be more appropriate to apply the same high value threshold across GB during the RIIO-T1 period to ensure a level playing field and avoid lost savings to consumers for projects in England and Wales.

2.9. Some respondents noted that, as a project is developed further the anticipated capital expenditure (capex) may increase, such that assets which failed to meet the high value criteria on initial assessment by the SO may increase in estimated capex to well above £100m, leading to missed opportunities for tendering. They suggested that we monitor the SO process and monitor the position in relation to those assets which at initial assessment fall below this threshold.

2.10. The majority of respondents supported our proposal that the high value threshold should relate to expected capex. Although some respondents indicated a preference for whole life costs to be considered, they acknowledged the difficulty in estimating this figure at an early stage of project development.

Packaging

2.11. Several respondents also provided their views on the processes for packaging projects. Respondents who commented on this issue were supportive of our detailed proposal to scrutinise the process of identifying projects including assets which are potentially suitable for regulation by a competitively awarded licence to ensure these are not deliberately packaged to avoid meeting the criteria. They noted that opportunities to split or combine projects could be used where the resulting project would comprise assets which would meet the criteria and potentially generate better value for money for consumers.

2.12. Some respondents suggested that some smaller assets could be effectively packaged together to meet the high value threshold which could increase the opportunities for competitive tendering, helping to develop the project pipeline and deliver savings for consumers. Some bidders also suggested that developing tender rounds could create opportunities to build efficiencies and reduce the cost of tenders. Some respondents also suggested that we may wish to consider implementing an upper threshold for assets above a certain expected capex, as investments above this value may limit competition through the exclusion of potential bidders or sources of investment, which could in turn limit value for money to consumers.

Responses to our proposals for identifying and progressing projects before a tender

Question 4: What are your views on the suggested process and roles for identifying projects for tendering? We have proposed specific roles for the SO – do you think there are any additional roles the SO could take on to support competition? What’s the most appropriate way to ensure that the Network Options Assessment (NOA) considers the widest range of network options, including those that would be tendered?

2.13. Most respondents were supportive of our proposal for the role of the SO in identifying suitable projects for tendering in the NOA report. Several stakeholders noted the importance of a clear separation between the SO and TO functions of National Grid Electricity Transmission (NGET), with several respondents favouring a move to having an independent system operator (ISO), to ensure the NOA is an independent assessment free from conflicts of interest.

2.14. However, NGET, SPT and SHE-T did not support the proposals. The incumbent TOs consider that the process proposed for identification and pre-tender arrangements for medium to longer-term projects lacks clarity around the obligations on the SO and TOs for system design responsibilities and could lead to duplication of

work and inefficiencies. They considered the process needed to better capture the input from the TOs in the process. SHE-T considered that the TOs are the party best placed to carry out preliminary works both during the RIIO-T1 period and in the longer term. NGET noted that the SO function does not currently have expertise in developing projects through the preliminary works stage and nor is the SO correctly incentivised to undertake preliminary works as there would be a reputational risk in the making commitments which the CATO may or may not honour. They instead suggest two CATO build models are introduced, one in which the TO undertakes all preliminary works prior to the tender and another in which the consenting function is tendered.

2.15. SPT also noted that the current obligation on the SO to develop the NOA does not capture large generator connections, non-load related projects and reinforcement works which take place within the existing system boundaries, potentially missing opportunities for competition.

2.16. The Scottish Government supported the role of the enhanced SO (ESO) but considered that Ofgem see this as limited to a management role rather than driving the design, consenting and delivery programme. They noted the importance of the ESO having adequate resource and leadership from Scotland based staff to manage the transition. They noted the need to ensure that the Scottish Government energy policy aims are not adversely affected by the transition to the ESO. They also suggested that the NOA options appraisal should include consideration of high-level economic, social and environmental factors which may impact project delivery.

2.17. Several respondents commented on the need for cooperation between the SO, incumbent TOs and in future the CATOs, to effectively identify system needs and agreed with our proposal for CATOs to provide input to the NOA process. Some respondents also requested more clarity on what the roles and interactions between these parties will be in the NOA process. Some respondents noted that consultation will be important to ensure the new NOA process develops effectively and that oversight by us will be important. The Scottish Government noted that it has had limited engagement with the SO to date, but considered that more engagement with the SO and other statutory consultees will be required. They considered that it is unclear which party will have responsibility for the initial stakeholder engagement in the NOA process and who will oversee handovers at various project stages.

Question 5: What incentives and obligations should the SO and TOs have for undertaking preliminary works for tendered projects, and is there any value in considering a success fee incentive?

2.18. The majority of respondents recognised the importance of good quality and timely preliminary works to the success of a project. Several respondents noted that it will be important that preliminary works are clearly defined and the responsibilities and obligations for parties clearly set out in licence conditions. Respondents also mentioned that issues associated with the transfer of consents to the CATO, stakeholder engagement, reporting and management should be clearly addressed. Some respondents noted that the preliminary works will need to be flexible to avoid restricting solutions CATOs may implement.

2.19. Respondents had mixed views on whether a success fee should be used to incentivise the party undertaking preliminary works and supporting the tender. The majority of respondents considered that a success fee would be appropriate to ensure that the preliminary works are delivered on time and to an appropriate quality. Some respondents considered that a balanced score card would be an appropriate form, while others suggested alternative approaches including: an assessment of preliminary works costs as is done for offshore tenders, a milestone-based payment triggered by the attainment of specific goals/works, and the potential for CATO feedback to be considered. However, several other respondents did not consider a success fee would be necessary as there will be sufficient obligations on the relevant party to ensure this goal is met. Several respondents who commented on this issue noted the importance that any success fee ensures value for money for consumers and consider any impact on existing obligations.

2.20. Some stakeholders responded to our proposal regarding liabilities for preliminary works – respondents had mixed views on this proposal. Some agreed with our proposed approach of using a licence mechanism to allow CATOs to recover the economic and efficient costs incurred due to problems with the preliminary works, however there were suggestions that this should be limited to items it was not possible to identify during the due diligence undertaken by bidders. Some respondents instead favour the use of liquidated damages, guarantees or warranties for the preliminary works which could transfer to the CATO.

Question 6: Should CATOs pay for the preliminary works at the point of transfer?

2.21. Respondents' views on this question were mixed. Some thought that the CATO should pay for the works following an ex-post cost assessment, similar to the costs paid by an OFTO after an offshore tender. Other respondents considered that the CATO should not be the party to pay for these works, or could identify no benefit in requiring them to do so. NGET noted that SO licence amendments may be needed to allow the SO to recover these costs correctly and to reflect the different roles of SO and TO. We seek to clarify here that this question was not whether preliminary works should be funded, but how this should be undertaken – whether it is efficient for CATOs to fund these and recover through their revenue streams, or whether the SO/incumbent TOs should recover directly through their own revenues.

3. Responses to our proposals for the tender process and regulating CATOs

3.1. We intend to consult in further detail on the tender models and the market offering for CATOs in the summer. We will identify in that document how we are responding to the issues raised in the responses to the October consultation, which are summarised in this chapter.

Responses to our proposals for the tender models

Question 1: What are your views on our proposed late CATO build tender model? Do you have any views on the basis of bids, use of cost-sharing factors or what risks, if any, it would not be efficient for a CATO to manage during construction?

3.2. The majority of respondents were supportive of the late CATO build model. One respondent suggested that our proposed process was too streamlined, with less opportunity to filter down the number of qualifying bidders competing during the invitation to tender (ITT) stage of the tender where bidding costs increase, which may deter potential bidders. There was a strong preference amongst respondents that the ITT stage of a tender should not commence until planning consent is obtained, with several noting this would be important to reduce the number of uncertain costs included within bids.

3.3. Some respondents noted that the late CATO build model offers limited potential for innovation as the detailed design may be highly constrained by the preliminary works obtained by the SO/TO, including within the parameters of planning consent. They noted that obtaining all consents may be difficult without knowledge of the detailed design and construction techniques and would therefore require engagement with the supply chain. As discussed in paragraph 1.17, some respondents suggested there may be challenges in transferring some consents to the CATO, particularly in Scotland due to the differences in planning law between Scotland and England and Wales.

3.4. Some respondents provided suggestions of the information they consider should be provided in the tender specification, while others were keen to see more details on what would be in the tender specification and data room. Some respondents were also keen to see further details of what we would evaluate at different tender stages. Some respondents noted that the evaluation of a late CATO build tender would need to consider the capability of bidders to mitigate environmental impacts and satisfy other obligations specified in the planning consent (discussed in paragraph 1.19). Some respondents also noted that the responsibilities and obligations which will be placed on the CATO by the planning consent must be made clear in the tender process. They considered that in some cases consents may

have been obtained by the TO/SO in a way which could be expensive and/or onerous for the CATO to fulfil.

3.5. The majority of respondents supported the proposal that bidders will be asked to provide a fixed cost subject to limited reopeners for risks during the construction and operations phase, for which it would not be economic and efficient to ask them to price into their bids. Respondents suggested such risks might include foreign exchange rates, movement in base interest rates, unexpected ground conditions, extreme weather events and financing costs beyond the commitment periods. However, some respondents consider that the use of sharing factors may be appropriate.

Question 2: What are your views on our proposed early CATO build tender model? Do you have any views on what tender specification would best facilitate innovative but deliverable bids, and how we can best manage cost uncertainty after the tender?

3.6. Some respondents, including all the incumbent TOs, were supportive of the early CATO build model as they consider this presents the best opportunity for innovation. Some other respondents considered that the early CATO build model may offer benefits for tenders in the longer term, but they noted they would want to see the late CATO build model established first. Some respondents did not think that the early CATO build model would realise benefits or was otherwise unworkable. Some potential bidders noted that the early CATO build model would be less attractive to them than the late CATO build model.

3.7. Responses from some potential bidders and those working in the transmission supply chain noted the potential risks of the early CATO build model, as well as the challenges it presents to our assessment of bids. Respondents generally agreed with the principal risks we outlined, around design changes linked to planning consent or project need. Several respondents noted that the evaluation of bids for an early CATO build tender would be complex and that this could add to bidders' perception of overall project risk. They stated that, in order to manage uncertainty and ensure the tender is attractive to bidders, the project specification would need to be well developed and the criteria for evaluation of tenders should be transparent and robust. Some respondents also noted that cost would need to be a less significant part of tender evaluation for the early CATO build model.

3.8. Several respondents suggested that a limited number of tender revenue stream (TRS) reopeners would be required to deal with cost uncertainty after the tender has completed, resulting from changes required during the consenting process. Some potential bidders noted that it is likely to be challenging for bidders to estimate fixed unit costs accurately so far in advance of the construction period, necessitating clear and appropriate indexation factors. Some respondents suggested that sharing factors may be more appropriate for some non-fixed costs, however some other respondents considered that a cost assessment process would be an appropriate way to control cost changes after the tender. Some respondents suggested refunding unsuccessful ITT bid costs, or a proportion of these, to help make the tender more attractive to bidders given the potential cost involved in

preparing bids. Some respondents also highlighted that potential bidders may require further information about how confidential information and intellectual property provided in bids would be used.

Question 3: Do you have any views on the best way to tender projects that use high voltage direct current (HVDC) technology?

3.9. Respondents had mixed views on the approach to tendering projects using HVDC. Some respondents considered that it is not necessary to adapt the tender process specifically for projects using HVDC technologies. Some respondents considered that tendering projects involving HVDC technology needs further consideration.

3.10. A number of respondents considered that these projects should be tendered using the early CATO build model as the design of the HVDC convertor can limit other design choices for the project and SO procurement of this technology may make the tender less attractive to bidders or reduce the potential benefits of tendering. However, some respondents supported the proposed approach of SO procurement of the HVDC system under a late CATO build tender model so long as the CATO's risk profile would not be adversely affected.

3.11. Two respondents did not consider that competing projects using HVDC technologies would lead to a greater number of suppliers. However, some respondents considered that the potential involvement of HVDC technology suppliers in bidding consortia could incentivise more competitive prices.

Question 4: Do you have any views on our proposal to prioritise late CATO build? Do you have any views on specific circumstances where early CATO build might lead to better outcomes than late CATO build?

3.12. The majority of respondents supported our proposal to prioritise the late CATO build model in the short to medium term, or accepted the need to use the late CATO model for any projects in the short term. One incumbent TO responded in favour of the early CATO build model only being used.

Question 5: Do you have any views on how we can mitigate the risk of a CATO not being in place?

3.13. All respondents who commented on this issue supported the proposal to introduce a 'CATO of Last Resort' mechanism to mitigate the risk of a CATO not being in place. Several respondents agreed that the need to use such a process would be unlikely and recognised that there are alternative steps we could take before implementing this mechanism, such as using a reserve bidder or re-running stages of the tender. Some respondents commented on the need for a robust evaluation of a bidder's ability to meet the obligations of the CATO and the need for us to monitor CATO performance and financial health. Several respondents requested further details on how the CATO of last resort mechanism will work.

Responses to our proposals for the CATO market offering

Question 6: What are your views on our proposed revenue package for CATOs? Do you have any views on the proposed duration of the revenue term, including how it links to the asset cost recovery period, and whether operations and maintenance costs can be fixed over this period? Do you have any views on our proposed approach to indexation, refinancing and enabling new asset investment?

3.14. The majority of respondents were supportive of the proposed approach that the CATO's annual revenue stream should be bid through the tender process and fixed, for as long as is economic and efficient to do so, without periodic review. The Sottish TOs did not support a fixed TRS approach; they expressed doubt that some operational costs could be fixed prior to construction and noted that not having periodic review would remove opportunities for us to fine tune incentives and that a fixed TRS could have unintended consequences for the CATOs approach to asset management. One suggested that an approach similar to the building blocks approach taken under RIIO would be more appropriate.

3.15. The majority of respondents considered that a 25 year revenue term would be appropriate and would attract a broad range of debt and equity investors. Several respondents noted however that some equity investors may prefer longer terms and suggested we should retain flexibility. Some respondents did not consider that there was enough evidence in the consultation to support setting the revenue term at 25 years. Some respondents, although not all, were confident that operation and maintenance costs could be fixed over a 25-year period, and generally respondents who expressed a view noted that financing considerations were most important in determining the duration of fixed revenue term.

3.16. Some respondents, including the incumbent TOs, suggested that the difference between revenue term and asset lifetime could disincentivise long-term decision making, noting that the licence obligations and incentives framework should ensure CATO asset decisions are taken on a whole life basis. Several respondents requested further details about the approach we will take to considering the residual value (RV) of the assets at the end of the revenue term, given our proposal to keep the same depreciation period for all new transmission assets. Several also noted that RV would be more complex than full asset depreciation over the revenue term. Generally respondents were of the view that, if bidders are to factor RV into their bids, clarity of the process and the extent to which the RV could change is needed upfront to avoid any unnecessary pricing of risk. Some respondents commented on the uncertainty over what would happen to the assets at the end of the revenue term and the potential for this to impact the outcome of the tender process. One respondent also noted the possibility of the current 45-year RIIO depreciation period changing in future.

3.17. The majority of respondents supported the proposed approach to indexation, although they had mixed views about what the most appropriate inflation index should be. Some respondents considered that indexation should be fixed for all

bidders and not biddable as this can add complexity to the evaluation process. The majority of respondents also supported our proposal to introduce a debt refinancing gain share mechanism as this would maximise benefits to consumers.

3.18. Our proposed approach to allow additional investments to CATOs' assets was also supported by most respondents. Several requested more clarity about how this process will work and noted that this would need to be made clear to bidders.

Question 7: What are your views on our proposed package of financial incentives for CATOs? Do you have any views on how we could structure an availability-based incentive to ensure CATOs operate their assets with a 'whole network' view? Do you have any views on whether there are circumstances under which 'payment on completion would not be appropriate to incentivise timely asset delivery?

3.19. The majority of respondents considered that an availability incentive would be broadly appropriate to incentivise the correct behaviours and that alternatives, such as 'Energy Not Supplied', would not be appropriate. Some respondents suggested that this should be paired with an asset management incentive to ensure the CATO's approach to operations and maintenance (O&M) considers the whole asset life or use weightings to ensure the CATO takes a whole system approach. Some respondents noted that the function of CATO assets might vary, which should be taken into account when setting incentives. One respondent noted the potential to financially incentivise performance parameters other than availability. A number of respondents agreed that there should be a cap on the penalties from the performance incentive, with many agreeing that 10% would be appropriate. However, others suggested that system security could be compromised by limiting the operational risk to CATOs.

3.20. Most respondents noted the need to ensure that CATOs coordinate with the SO, TOs and other network users. Some respondents suggested that the proposed approach would not provide sufficient flexibility to support the efficient operation and design of the whole electricity system due to different commercial drivers for CATOs and TOs. They noted that CATO behaviours could potentially negatively impact TOs and DNOs and their RIIO performance, and suggested that CATO incentives should align with RIIO licensees.

3.21. Since the consultation we have been developing our thinking on performance incentives further, including through discussions with industry parties. We continue to think that an availability-based mechanism is the most suitable way to incentivise CATOs, and we plan to publish further details on the possible structure of the incentive in our next consultation.

3.22. Most respondents considered that payment on completion would be an appropriate incentive to ensure CATOs deliver assets on time. Some respondents noted that for projects with inherently long construction timelines, beyond the control of the CATO, financing costs would increase meaning delaying payment could be less efficient. In these situations respondents supported the proposal to allow

earlier commencement of some of the revenue tied to the CATO's achievement of milestones. Some TO respondents considered that payment on completion is an asymmetrical incentive for timely delivery of assets as any cost saving to consumers of a delayed payment to the CATO may be outweighed by resulting constraint costs.

Question 8: Are there other types of incentives not covered in this chapter that you think should apply to CATOs?

3.1. Some respondents suggested that CATOs should be subject to the same incentives and outputs as the TOs, to ensure a holistic approach to regulation and network management. In particular a stakeholder incentive was suggested to ensure that customers receive a consistent level of service regardless of the identity of the TO or CATO. Some respondents suggested that some non-financial and performance based incentives that may be appropriate for CATOs. Several respondents also suggested that CATOs should be incentivised on environmental and social impact measures (discussed in paragraph 1.19).

3.2. Some respondents suggested that further consideration should be given as to whether a transmission losses incentive should be included. Some respondents, however, did not consider that any other incentives need apply to CATOs.

3.3. One generator noted that CATOs should be expected to accede to the industry codes and if appropriate the project must adhere to any Nuclear Site Licence Provision Agreements put in place.

4. Responses to our proposals for mitigating conflicts of interest

4.1. Our main document provides further detail on our proposed measures for mitigating conflicts of interest for any projects tendered during RIIO-T1. We have developed these proposals having regard to the consultation responses and the main document highlights the measures we propose to respond to particular comments raised.

Question 1: Are there any risks or conflicts of interest arising from the SO's role that we haven't identified?

Question 2: Are there any risks or conflicts of interest arising from the participation of incumbent onshore TOs that we haven't identified?

Question 3: Are there any additional conflicts of interest that we haven't identified?

4.2. Most respondents agreed that those conflicts identified in the consultation are the key conflicts and that they consider these to be important. Respondents also identified some additional conflicts.

4.3. On conflicts arising from the SO role in competition, respondents agreed that the SO's proposed roles give rise to conflicts of interest and agreed with the conflicts we set out in the consultation. Some respondents identified additional potential conflicts or perceived conflicts for late CATO build tenders where the SO will carry out the preliminary works in RIIO-T2. These include a lack of transparency between the SO function and NGET, and the potential for the SO to deliver the preliminary works to timescales that make competition difficult. Respondents also suggested that the SO may favour TOs or particular CATOs when operating the system.

4.4. Consultation respondents also agreed with our identification of conflicts arising where incumbent TOs have completed preliminary works prior to a tender. Respondents identified additional conflicts including: the involvement of contractors in preliminary works, the potential for TOs to bid for O&M sub-contracts, and for contractors who typically work for TOs to be disincentivised from participating in onshore tenders. Respondents also noted the potential for TOs to benefit from their existing price control arrangements.

Question 4: What measures do you think would be appropriate to mitigate the risks and conflicts of interest? What additional conflict mitigation measures would be needed if the SO takes on a broader role in supporting competition?

4.5. Some respondents considered our proposed mitigations would be effective to mitigate the conflicts of interest identified. However, several respondents supported greater separation between the SO and TO functions of NGET, with several favouring a move to an ISO. Some respondents also considered that if NGET is to compete for tendered assets it would be necessary for it to do so via a separate bidding business to mitigate these conflicts of interest. Several respondents noted that, where a TO has done preliminary works for a project it is important that the TO makes all relevant information available for the tender.