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Dear Joe

Extending competition in electricity transmission: criteria, pre-tender and conflict mitigation arrangements

This response is on behalf of National Grid Electricity Transmission plc.

Executive summary

We welcome work to explore the potential for extending competition in electricity transmission. There are elements of the consultation that we support. In particular:

- We are pleased that bespoke impact assessments will be conducted for RIIO-T1 projects that are being considered for tender. In our view, individual impact assessments for RIIO-T2 projects would also be appropriate. Sufficient time exists to undertake such assessments and given that there will be different knock-on impacts on the operational resilience of the network from each project that is contested, this opportunity should be utilised. It could well be that RIIO-T2 projects present a harder challenge than those in RIIO-T1 and careful consideration will be needed. It is vital that the voices of developers, customers and all who might be affected are properly heard as part of any bespoke impact assessment process, for both RIIO-T1 and RIIO-T2 projects.

- We agree with the new, high value and separable criteria. Albeit there are areas where further detail would be helpful, for example as to whether risk and contingency allowances are factored into the £100 million threshold, and if so how.

- We think that the high level proposals around managing incumbent Transmission Owner (TO) conflicts of interest are workable and are consistent in terms of principle with many of our existing ways of working. Albeit, any costs that arise either as a direct result of implementing further ring-fencing or as a consequence of having to manage increased complexity within our business, will need to be funded via our allowances. We would welcome further dialogue with Ofgem to ensure we are clear what these proposals mean in more detailed practical terms for National Grid. For example, to ensure that our assumptions with regards to what Ofgem's managerial separation proposals might entail would be acceptable. It is also important to ensure that potential conflicts of interest for other bidders (e.g. confidentiality agreements) are identified and mitigated early in the

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process. The benefit of this is that all who might want to bid know which potential conflicts of interests need to be managed, and how, well ahead of a competitive process being initiated. This is particularly pertinent given that a number of contractors might have conflicts of interest, as they may be consulting for others and then also subsequently choosing to bid in some form for contested work.

There are also some areas within the consultation that remain of concern to us.

The need for more detailed regime proposals

- We outline in more depth later in this section, specific examples of areas where we feel greater detail is needed within these proposals. As a matter of urgency we wanted to also highlight upfront in our response our more general unease on this point. In our view there is a huge difference between high level conceptual theory as to what a competitive regime might look like and an actual, practical, fully designed set of arrangements that can be properly understood by all parties. Many critical questions remain and it is vital that Ofgem really focus on the detailed mechanics (and associated roles and responsibilities) at a level of granularity significantly beyond that which we have seen to date. It is only through such a focus that all who are affected by competition will properly be able to prepare in a way that will maximise the potential benefits that competition can ultimately bring to consumers.

The role of the System Operator (SO) in consenting

- Most critically, we remain of the view that it is not in the interest of consumers for the SO to undertake consenting and pre-engineering activity on behalf of others. There would be significant cost inefficiencies that would flow from having a consenting capability in both the SO (for contested projects) and in the TOs (for projects that are not contested.) Separation of consenting (with the associated design of environmental mitigations) from the overall design and delivery of network options also risks lower quality developments in terms of scheme optimisation and meeting customer and public needs (which could be mitigated through utilising the early model that we continue to strongly advocate). Moreover, future SO philosophy is based on adding consumer value by creating the right frameworks through which competitive markets will drive innovative solutions. This SO philosophy seeks to harness the capabilities of potential service providers rather than short-circuit them through undue micro-management or the SO undertaking these activities itself. We have committed to an exciting package of SO work that focusses on security of supply, flexibility, whole system solutions, facilitating network competition whilst ensuring a level playing field and increasing SO independence. It is important that the SO is not distracted from delivering in these critical areas by taking on activities that are not a good fit in terms of skills, capabilities or focus. In our view, detailed consenting and engineering activity is not aligned with a vision of the SO which is focussed on setting frameworks to enable market participants to compete. We are also clear that as a commercial business, consenting on behalf of others is not a good value opportunity for us and is not something that is in our shareholder interests.

- We have consistently made these points in previous consultation responses and in a wide range of industry meetings and bi-laterals with Ofgem. We are concerned that Ofgem are continuing to develop the enduring regime predicated on the SO taking on a role that we have expressed extreme reluctance to undertake – and without any real detail as to the associated package. The development of a workable early tender model

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would mitigate many of these issues, whilst also adding significantly more potential for consumer value from competition. Championing and fostering innovation is at the core of our value set as an organisation and we believe that innovation should also be a critical component of a competitive regime. The early model enables potential bidders to develop innovative ideas across a wide range of areas (whereas the late model essentially facilitates a competition based solely on cost of capital and construction costs.) The greater the scope for innovation, the greater the capacity that exists to deliver value for consumers. Furthermore, if the same party undertakes consenting and construction, greater overall value is likely to be achieved across the project due to fewer interfaces and handovers and enhanced ownership. Given all of this, we still passionately believe that the early model should be seen as the default arrangement in RIIO-T2, just as it is internationally. Hence we look forward to continuing to work with Ofgem and the industry to help develop this. Indeed, it is our understanding that many other industry players, including many potential future bidders, also favour the early model – and we think the reasons for this are clear.

- If very limited circumstances arise where an enduring late model is still to be utilised, both the options of the incumbent TOs undertaking consenting and a third party undertaking consenting need to be explored in much greater detail before decisions are made. We strongly favour the adoption of a third party model in this instance. As this is a RIIO-T2 issue there are still nearly five years before it becomes a "live" challenge. Therefore, there is ample time to think this through properly and that time should be fully utilised. We urge that Ofgem do not rush to form RIIO-T2 solutions or to allocate RIIO-T2 roles at this point. Rather, we believe the industry should focus in the first instance on implementing the transitional arrangements prior to evaluating RIIO-T2 issues much more thoroughly – and with a strong bias toward the early regime.

Clarity regarding liabilities

- A lack of clarity exists as to the liabilities that might exist under the transitional regime (and under the enduring late regime) should a TO ultimately transfer a project that it has developed over to a CATO. In our view it should be made clear that no ongoing liabilities exist for the TO. The incumbent TO is responsible for the consenting and pre-engineering in these circumstances and post consenting should have a clean break in terms of ongoing liabilities. This is an important area, where much more detail is needed and we believe Ofgem and the industry should focus on developing detailed proposals on this important topic.

Other issues

- We understand that under the current proposals only Strategic Wider Works (SWW) projects are eligible to be considered for competition in the RIIO-T1 period. However, should any non-SWW projects be put forward for tender under the transitional arrangements (potentially spanning RIIO-T1 and –T2), the regime needs to ensure that TOs are reimbursed for those preliminary works that are undertaken.

- More generally, further work is required on the interactions and handovers between the TO and SO in relation to projects that span the RIIO-T1 and RIIO-T2 price controls. Whilst we strongly resist the idea of the SO taking on a role in consenting and engineering as a matter of principle, principle aside, it is not clear to us how Ofgem envisage that this might work in practice. Preliminary works are currently underway for a

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number of projects that might be determined as suitable for competition and it is unclear to us how any potential handover between TO and SO (if any) might be managed for in flight projects. This has a significant impact on project planning, resourcing and stakeholder management and we are nervous as to how we might manage this effectively, given we do not fully understand the proposals. We would also welcome more detailed implementation plans from Ofgem, particularly in relation to Licence and Code based drafting, and where and what the handover from a TO developed T1 project to a CATO looks like given the aspiration to potentially run competitive processes from 2017.

- Regarding the transfer of consents, permissions and rights to enable CATO construction, there are a number of contractual issues that need to be worked through to ensure these proposals are viable. We agree with the principle that non-physical assets associated with a project (consents and rights etc.) would need to be transferred in order for the CATO to successfully undertake construction and operation of those network assets. A number of contractual complexities need to be worked through to ensure that all these consents and obligations are fully transferred. Development Consent Orders (DCOs) can be transferred to a third party under current legislation in England and Wales. However, Permitted Development rights, which are available to National Grid as the owner of network assets, cannot be transferred without an administrative Order to change the current legislation. We note that issues also exist in Scotland in these areas and we would welcome a further steer from Ofgem as to how they see these questions playing out in a Scottish context.

- We welcome the fact that Ofgem are planning to run an impact assessment on potentially competitively tendering the connection of Nugen's proposed nuclear station in Moorside, later this year. However, we think significantly more clarity is needed as to exactly what form this consultation might take, as even the increased uncertainty that might come about simply because this process is commencing could add to the risk of project delays. We will respond in more detail on this project, when the specific consultation is published. However, it remains our view that the timescales for contesting this work are extremely challenging and the onus will very much be on Ofgem to demonstrate that a delay to the development of this critical national infrastructure does not come about.

Our answers to the specific questions raised in the consultation are contained in the attached Appendix 1. We are happy to discuss our views contained within this letter and appendices further should that be helpful. For further details, please contact Ben Graff ben.graff@nationalgrid.com.

Yours sincerely

[By email]

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Appendix 1: Answers to consultation questions

Chapter: Two

1. ***What are your views on our proposed arrangements for ownership and responsibilities? In particular can you provide examples of specific scenarios where it may be necessary for ownership transfer of existing physical assets to occur between network operators?***

With respect to the proposals to transfer non-physical assets, we agree that this is necessary to enable the appointed CATO to construct and deliver the assets and do so according to the terms of the planning agreements. The proposal to transfer these assets at "nil value," may be reasonable provided that the costs incurred to obtain them can be fully recovered through the allowed revenue of the relevant party.

We anticipate the circumstances that would require the transfer of physical assets to be rare, however, we agree that a sensible approach is to consider this on a case-by-case basis for individual projects. Any consideration of physical asset transfer should include an assessment of the full circumstances of the project and the consequential impacts of different packaging options. For example, under some circumstances it may be neater to avoid a meshed network (with varying ownership across assets), however we would want to avoid giving rise to any negative impacts to the network's electrical resilience and system operability as a result of transferring assets to achieve a more convenient alignment of ownership. Whilst obligations to adhere to the terms of the SQSS should provide a level of protection, it would be prudent to take into account the impact on network operability and co-ordination ahead of any proposed physical transfer. When assessing asset transfers, transferring existing physical assets between the DNOs and a CATO such that the CATO project can be safely delivered, the DNO can maintain its service to its customers and deliver its RIIO-ED1 outputs and the CATO can meet the mitigation requirements of the DNO, should also be considered.

2. ***Do you agree with our proposed principles for packaging projects?***

We support the fundamental principle that a given project or project package should be based on a common single need. This will ensure that questions as to whether a project should proceed are considered holistically. There would be significant risks if a project package taken forward to competition in effect consisted of numerous smaller projects that were driven by separate needs. Clearly, the economic case for taking a package forwards may be particularly exposed if the needs case for any one of its constituent projects is vulnerable to being revised according to changes in operating conditions or underlying assumptions. It is also likely to be challenging to bundle projects where those network options have entered the NOA process in different years and been developed to different levels of maturity.

Subject to an impact assessment to ensure that there is not a disproportionate increase in transaction costs resulting from the creation of more interfaces and handovers and the points above in relation to single project drivers, we agree that it may at times be sensible to split very large projects. Where projects are divided this would need to be undertaken with careful planning and co-ordination.

The approach to packaging should assess the most appropriate project option on a case by case basis taking into account the associated interfaces, interactions and risks. In any circumstance it is critical that responsibilities, accountabilities and rules of engagement between

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different parties are transparent and clearly defined. The industry codes and standards play a key role in providing this clarity. We would also welcome the opportunity to work more closely with Ofgem to agree the principles the SO might follow in assessing how work might potentially be packaged.

3. Do you consider the processes we have set out for determining which projects to tender are appropriate?

We are pleased that Ofgem will undertake individual impact assessments to evaluate the suitability for competition of potential RIIO-T1 projects. This is a pragmatic approach that allows the full circumstances of a project to be taken into account. This should not be confined only to RIIO-T1 projects as there is merit in adopting a similar approach for those in RIIO-T2 for which the system need for construction to begin is already within a certain lead time. Indeed in many ways, RIIO-T2 projects present a harder challenge to ensure the right evaluation is made as to the cost benefits and other implications of tendering relative to the potential impact on the system. Hence, all the more need for a bespoke impact assessment. Given this, as well as meeting new, separable and high value criteria, there should be consideration of the sensitivities of assumptions, the urgency of need and the implications of the risks of any delays inherent in the assessment of any project. It is critical that such impact assessments allow all relevant voices to be heard, particularly those of the Developer and others who might be directly affected, should delays occur.

Whilst the high level draft processes set out in the consultation appear broadly appropriate, they do seem to assume clearly delineated stages in the current approach to progressing projects. However, in reality, seeking to deliver to customer dates or network need timescales can lead to activities being undertaken in parallel. Projects that might be subject to a competitive tender in the future will need to be approached in a more sequential way in order to manage the transfer of activities and responsibilities over to the CATO at the appropriate point in the process. This greater need for sequential working will inevitably impact on delivery timescales for future projects to some extent.

4. Beyond the NOA and the connections process, what other routes should we be utilising to identify suitable projects for competition, e.g. for non-load projects?

We welcome the clarity of the new, high value and separable criteria and believe that these provide a useful framework to help identify projects that might potentially be contested. We are continuing to work proactively with the industry to develop the NOA year on year to ensure that it provides a helpful guide to the industry as to future potential work on the system. All of this means that we are in good shape to play our part in enabling the industry to understand what future work might potentially be contested.

In relation to non-load projects, a NOA approach would require the TO to set out holistic asset replacement strategies for SO assessment. Whilst this might be possible, there is a risk that it might stifle opportunities to act in a timely manner as new asset information emerges. It would also move asset management decision making away from the asset owner with its greater understanding of the capabilities of the physical assets and its legal obligations with regard to public safety and environmental management. This is a really serious issue as under the current regulatory arrangements asset owners are incentivised to use their greater asset knowledge to deliver reliability at the least cost to the consumer. This would be diluted should an approach similar to NOA be adopted. In relation to competition, a tendered package would necessitate a disaggregated bundling of discrete assets, most of which would have a significant degree of

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interface with, and dependence on, incumbent TO assets and infrastructure. This significant increase in ongoing interface management and complexity could severely detract from any potential benefit that competition might have delivered.

5. What do you consider should constitute 'early development works' for options ahead of their assessment in the NOA process, i.e. what works should be undertaken in order to ensure that the most appropriate tendered options are developed for submission at the initial tender checkpoint?

The underlying philosophy should be based on the TO developing options, which the SO then assesses. Should the SO identify that options have been missed, it should then be down to the TO to develop these through ongoing dialogue with the SO. We recommend that a clear process is set out to define when further development work on options is required following a positive recommendation from NOA as we do not think it should necessarily be carried out for every option identified. The default position (para 3.10), that a TO should not undertake any supply chain procurement or construction work for a competed SWW project, needs further consideration. In some cases it may not be clear how a project is to be delivered without undertaking the time efficient activities to meet the completion date, including engaging with supply chains. However, we do welcome the view that these questions will be considered on a case-by-case basis. If, and where, Ofgem identifies and requires any additional preconstruction works (para 3.11) to be undertaken by the incumbent TO, this should be subject to additional funding.

Projects that come under consideration of the NOA process in a given year are likely to be developed to different levels of maturity and may not be easily comparable. For example, a new solution, making use of innovative technology, which is identified by the SO in one year, will not be easily comparable to a solution that has been developed over up to eight years by an incumbent TO. It is therefore not likely to be an efficient use of resources, or in consumers' interests, to always work up all potential solutions to the same standard as part of the NOA process.

As part of the ongoing development of the NOA process, we look forward to working with Ofgem over the coming months to develop what would be appropriate to include in "early development works."

Chapter: Three

6. What are your views on the suggested process for carrying out the pre-tender roles?

The suggestion that onshore virtual data-rooms will "broadly mimic" those which were established for the OFTO regime is one we would push back on. The onshore and the off-shore regimes are very different and the data-rooms will need to facilitate the competition for assets at very different stages of development. The tender process for the off-shore regime has been with respect to already built assets with the data room populated by the developer and managed by Ofgem. This contrasts with the onshore regime for which, under Ofgem's proposals, the TO/SO might have deeper roles in supporting the tender process which might create different perceived issues that need to be managed. We talk in more detail about data rooms in our answers to questions 7 and 8. However, the more generic point we would make here is that these are very different regimes, the details of which need to be developed with a bespoke focus on the particular challenges that are being faced. It is important that an over-reliance on off-shore

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analogies is not used as a substitute for a full analysis and subsequent development of appropriate ways forward for the onshore regime.

We would also highlight the point we have made in previous consultation responses that the pre-tender processes inevitably will add significant time to the development cycle for a contested project. These are, by their very nature, really long processes and this will always need to be factored into any decision as to whether or not to tender.

Reiterating our response to question (3) we suggest that a further process is developed to specify arrangements for transitional projects that span RIIO-T1 and T2 arrangements (for example, the arrangements where a DCO process is required to commence around 2018).

In order to gauge the effectiveness of the suggested process, we would like to see greater clarity on the proposed steps by which a project would be progressed to starting the preliminary works, following its approval by Ofgem, after passing through the NOA process. We have outlined above our strong reservations in relation to the SO undertaking consenting activity on behalf of others. Of the two options that remain (TO consenting and third party consenting) we strongly advocate a third party consenting model.

7. Regarding preliminary works and the tender specification:

- ***a. What are your views on the scope of the baseline tender specification?***
- ***b. How likely is it that additional preliminary works will be required, and if so, what types of works are likely to be required?***
- ***c. What are our views on:***
  - ***i. The role of bidders in identifying the need for further information / additional preliminary works (e.g. additional independent surveys) to inform robust bid assumptions?***
  - ***ii. The most efficient process for enabling this?***

A critical facet of seeking to minimise delays and cost that might occur through competing a project is getting the bidding process right first time and having the fact that the arrangements are seen by Ofgem as being fit for purpose validated. Further work is needed to ensure agreement with the industry as to precisely what information should be placed within the data room and how this might be managed. By getting this process right and signed off by Ofgem, the need for further information and additional independent surveys/ preliminary work should theoretically be minimised. However, all of this is not without its risks. These risks do have associated impacts on costings, resourcing requirements and timings. It is possible that some bidders might seek to engage us in onerous further engagement above and beyond what might be considered reasonable. This could impact on project timescales, could require us to take on further resourcing and will likely result in our costs increasing. All of this needs to be factored both into our funding arrangements and the overall project planning. Similarly, further optional studies undertaken by bidders must not be allowed to impact on project delivery timescales.

With regards to the specification of preliminary works to support the tender process, we agree with the principle of proposing a baseline tender specification and specifying any additional bespoke requirements for a given project on a case-by-case basis. When determining the information requirements for the specification, it is important that they can be fully justified as being proportionate for a project and are therefore in the best interests of consumers, balancing the information requirements of potential bidders with the costs of undertaking those studies.

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We strongly recommend that the composition of the tender specification, and in particular the scope of any works in addition to the baseline, should be agreed well in advance to enable them to be completed ahead of the relevant tender checkpoint so they can be considered in that assessment. An approach predicated on a base set of requirements plus project specific works to minimize bespoke discussions should mitigate the risk of a project's progress being delayed unnecessarily. An unconstrained iterative process should be avoided. Since the nature of some of these surveys and studies is that they can require seasonal input, it is imperative that sufficient time is allowed for them to be carried out.

8. What are your views on the proposed arrangements for the data room and bidder clarifications?

We have outlined in response to question 7, both the steps that need to be taken to best facilitate the use of a successful data room and the potential risks that will need to be managed and costed. We would welcome the opportunity to liaise with potential bidders for onshore work, to further develop the data room proposals, well ahead of the first tender. This should ensure we are all as well placed as possible to equip high quality data rooms, which minimise the potential risks of project delays that could occur if lots of further clarification is necessary.

9. What are your views on our proposals regarding the funding of preliminary works and tender support activities in RIIO-T1?

It is vital that the costs of carrying out preliminary works, both those undertaken in RIIO-T1 and under the enduring regime, are fully funded and recoverable. These activities have direct bearing on the reliability of a project progressing through construction and fulfilling these comprehensively in the early stages should help de-risk the project's completion at later stages. We have highlighted earlier in this response the vital need for more clarity on funding arrangements, particularly should none SWW RIIO-T1 projects be contested.

10. Do you have any initial views on risk allocation across the preliminary works party and the CATO?

We have already highlighted our clear view that TOs should not have any enduring liabilities beyond the consenting and pre-engineering stage should a project ultimately be handed over to a CATO. CATOs will as part of their due diligence have the opportunity to assess the information put into the data room and so are able to assess the risks and opportunities themselves which should facilitate a clear and clean separation between initial project development by a TO and continued development and delivery by a CATO.

Chapter: Four

11. Do you agree with our proposed requirements for incumbent TOs to mitigate potential conflicts of interest, where they are both bidding for and developing a project in RIIO-T1?

As an organisation we have considerable experience of following compliance and business separation processes both to manage potential conflicts of interest and to provide a strong platform for industry confidence in our ability to manage our operations fairly. We support the fundamental principle underpinning these requirements, which ensures that the framework for tendering allows all participants, both incumbent TOs and other bidders, to compete fairly and on a level playing field.

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We support Ofgem's high level conflict mitigation proposals for incumbent TOs which outline the minimum business separation requirements. In order to ensure that our interpretation of the requirements is aligned to Ofgem's intent, we would welcome further clarity as to what these proposals might mean in practice and will seek further guidance from Ofgem on this, in particular on details under the proposals for managerial, employee and physical separation.

With regards to the proposed restrictions on employee transfers, we welcome the suggested mechanism of precluding any moves into the bidding team of relevant employees within a time frame that relates to that of the tender process, and these rules should be clearly set out. This is a pragmatic and transparent approach and avoids ambiguity when determining the status of employees. Further clarification on how these rules apply to employees from shared services functions would be similarly helpful.

12. Is internal scrutiny of the arrangements the TO has in place to mitigate conflicts of interest sufficient, or would there be significant additional value in having an independent party scrutinise an audit the TO's arrangements?

In line with our electricity and gas licence conditions, National Grid already has an appointed Compliance Officer with a reporting line independent of the TO business to provide internal scrutiny and report on the compliance procedures followed by our regulated businesses. Annual compliance reports and certificates are approved by resolution of the NGET Board of Directors, which include Sufficiently Independent Directors required by our licence. These reports and certificates are provided to Ofgem and published for public view on National Grid's website. Ofgem can also direct the appointment of an Independent Examiner to provide written compliance reports as may be required. In our experience these arrangements are both effective and proportionate, and we believe that having a permanently appointed independent party to scrutinise arrangements may add unnecessary costs for consumers. Given all of this, we would not support separation up to Board level.

13. Do you agree with our proposal to manage conflicts for other bidders?

We agree that the proposed high level measures are appropriate, but welcome further clarity as to what they mean in practice. We agree that managing potential conflicts of interest for contractors will be important and indeed highlighted this in the introduction to our response. Timing will be important. For example, once development work is underway on a project it might be too difficult for a contracting party to sign a memorandum of understanding (4.3.2.) and to put in place the appropriate Chinese walls, should that project subsequently contested. Hence the need for clear, upfront visibility as to what might be required, from whom and by when, to enable all parties to best organise themselves such that they can compete. It is only if the arrangements are sufficiently clear to facilitate this, that the most effective competition can be run in the best interests of consumers. Equally, as previously touched upon, compliance arrangements (4.26) have a cost and this cost will need to be funded.

We would also note that there is the potential for individuals to move roles externally as well as internally and for organisations to use similar contractors for specific elements of work involved in pre-construction activities. The obligation to sign a 'conflicts of interest declaration' is a key safeguard and in our experience we have found that the obligation on individuals to sign a personal declaration is a very effective means of self-assessment.

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Appendix 2: Comments on CEPA report 'Evaluation of OFTO Tender Round 2 and 3 Benefits', March 2016

The conclusions of the scenario analysis in the Updated Impact Assessment[1] appear to rely in large part on the claimed savings under the OFTO regime, which have been taken from the recent report by CEPA: "*Evaluation of OFTO Tender Round 2 and 3 Benefits*", March 2016[2]. These claimed benefits and savings depend on certain assumptions and comparisons, and as a result any headline figures for the estimates of savings that are based on the report need to be expressed and interpreted carefully.

In CEPA's report, in making comparisons between the OFTO regime and the regulated counterfactuals 3 and 4, savings are claimed in relation to (i) operating costs and (ii) financing costs. We examine the assumptions underpinning each of these in turn.

Operating Cost Savings

The estimates of operating cost savings depend critically on the assumed levels under the counterfactuals. CEPA appear to rely on the assumption that the operating costs for the initial "price control" for OFTO projects under a regulated counterfactual can be estimated from the level of these costs as bid by incumbents several years ago in just two of the TR1 projects. Since the process of setting regulated price controls involves a close scrutiny of cost forecasts, this assumption could be expected to lead to overestimation of the operating cost savings from the OFTO regime.

In addition:

- CEPA's analysis assumes that the operating costs for the successful bids genuinely reflect a true level of O&M costs for these assets, but it has previously been noted (e.g. in the earlier BDO/CEPA report[3] on OFTO tender round one) that for some OFTO projects this is not the case.
- It ignores the potential synergies if a single network owner had owned all the OFTO assets. (CEPA's report refers to this unquantified benefit as "lost opportunities for co-ordination".)

Financing Costs Savings

Comparison to Regulated Network Counterfactuals

In relation to the claimed financing cost savings relative to the regulated counterfactuals, CEPA note that the OFTO opportunities benefitted from significant de-risking making them attractive to prospective bidders[4]. Any transfer in risk to consumers under the OFTO regime needs to be considered alongside any claimed savings in financing costs but this hasn't been quantified.

The financing cost savings for regulated network assets (counterfactual 3) are derived from comparing the allowed financing costs for those against the financing costs under the OFTO regime. Regulated network assets have been constructed and financed over many years, and their financing cost reflects the network owner's portfolio of assets and activities. Cost of capital and most obviously borrowing costs vary over time, so it is misleading to compare estimates of

[1] In particular, see para. 4.11, "*Extending competition in electricity transmission: impact assessment. Updated Impact Assessment – Supporting Document*", Ofgem, 27 May 2016

[2] The 23-34% figure seems to be taken from the figures in Appendix 1 Table 5 of the new Impact Assessment, which shows claimed savings from the OFTO regime c.f. counterfactuals 3 and 4 (i.e. the "regulated network" and "regulated specific control" counterfactuals) based on CEPA's report.

[3] See "*Evaluation of OFTO tender round TR1 Benefits*" page 52, BDO/CEPA, May 2014

[4] See CEPA report "*Evaluation of OFTO Tender Round 2 and 3 Benefits*", March 2016, page (iv)

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the cost of debt raised on OFTO projects over a short timeframe to the cost of debt that is allowed in network price controls.

It follows that the comparison to financing costs under counterfactual 4 (regulated 'specific control') would seem to be a potentially more valid comparison, but in comparing the OFTO regime to counterfactual 4: (a) it is not clear why cost of debt would be substantially cheaper under the OFTO regime; and (b) as with CEPA's other counterfactuals, any differences in cost of equity that are claimed cannot be seen in isolation without also considering the differences in risk. To the extent that differences in cost of equity result from a transfer of risk to consumers, there is no overall benefit to consumers from this.

Comparison to Merchant Counterfactuals
Reservations similarly apply to the savings claimed in CEPA's report in relation to the merchant counterfactuals (counterfactuals 1 and 2). For these counterfactuals, the claimed savings related to financing costs only, but as the report itself notes this financing cost saving is driven by a "*merchant risk differential*" between the OFTO regime and merchant counterfactuals. In other words, the OFTO regime transfers certain risks to consumers which would be faced by developers under the merchant counterfactuals, but this risk transfer has not been quantified or priced in the analysis. If, as well as financing costs, the costs of bearing risks were taken into account, it is unclear from the report why there should be any overall net benefit for consumers.

Terminal Asset Value
We note that CEPA's report identifies that another source of the claimed savings in financing costs (under all counterfactuals) may be the treatment of terminal value in the modelling. Whilst the costs of the counterfactuals were based on a 20 year revenue stream assuming that the assets are fully depreciated after 20 years, CEPA explained that "*in contrast, our understanding is that for a number of projects (in all tender rounds) OFTO bidders may have included a terminal value, which for pricing purposes, allows them to reduce their required TRS (other things being equal).*" Since CEPA's costs under the OFTO regime are based on the NPVs of the Tender Revenue Streams bid by the ultimately appointed OFTOs, this difference in treatment of terminal value will increase the claimed savings from the OFTO regime.

Concluding Comments
The above observations cast doubt on the quantified values of claimed benefits of the OFTO regime, but CEPA's report also discusses the distribution of any savings or benefits between consumers and offshore wind generators. It is not clear from this discussion how much of the claimed benefits, even if they were well-founded, would have flowed through to consumers, and the report seems to suggest[5] that for the TR1, TR2 and TR3 projects consumers might only benefit from a relatively small share of any savings.

It is clear that the results presented in CEPA's report into the possible savings from the OFTO regime need to be treated with caution, given that:

- the estimates depend on assumptions which may be uncertain;
- costs to consumers of the risks transferred to them under the OFTO regime are ignored;
- in some respects the comparisons have not been made on a like-for-like basis; and
- it is not clear how much of any benefits will flow through to consumers.

For these reasons, it would not seem appropriate to extrapolate the claimed savings from the OFTO regime to onshore competition.

[5] See the discussion in Section 7 of the CEPA report "*Evaluation of OFTO Tender Round 2 and 3 Benefits*", March 2016, starting on page 49.