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Dear Gordon,

Re: Extending Competition in Electricity Transmission: Tender Models and Market Offering

On behalf of Electricity North West Limited, we appreciate the opportunity to respond to this consultation. We welcome the ability to contribute to this latest development in this area and appreciate the dialogue with Ofgem to date as to how the implementation of competition in electricity transmission impacts on distribution customers in the North West.

As previously discussed with members of the ECIT and Distribution teams, our priority is to ensure that DUoS customers are appropriately and fairly treated in the event of a project being awarded to a Competitively Appointed Transmission Owner (CATO) in our area; most significantly the potential North West Coast Connections project. Whilst the current consultation takes the thinking to a further level of detail, our view remains that some specific aspects of implementation have not yet been adequately addressed.

Where we are in a position to provide a response to the detailed questions set out in the consultation, we have answered these in Appendix 1. In addition, there are some high level points that we would like to draw your attention to and these are set out below.

Interface with Distribution

As mentioned in previous responses, we are concerned that the proposals are very focussed on transmission and there is a risk that at this stage they may not adequately take into account the potential effects on other sectors. We appreciate the time taken by members of the Ofgem teams to discuss our concerns to date, and following your review of the latest consultation responses we believe further discussions would be beneficial. Below I have outlined a number of the more significant points.

The section on transfer of preliminary assets seems to suggest that Ofgem envisages the Transmission Owner (TO) or potentially System Operator (SO) as being the legal owner of all relevant assets. However, we can envisage numerous instances where the TO may require, and therefore fund, works to be undertaken on the distribution network. In such instances, the assets would belong to the Distribution Network Operator (DNO) rather than the TO. Further consideration may need to be given as to how such instances are handled.

In relation to Incentives, the paper provides an overview of Ofgem's thinking regarding Incentives for the CATO once the assets are operational. However, we suggest further work may be appropriate to consider the interaction of incentives during construction. The actions of the CATO could significantly impact on the reliability of neighbouring distribution (and

transmission) networks. The owners of these assets will continue to be incentivised during the period as part of the respective price control framework. Clarity as to how such interactions will be handled would be beneficial for all parties.

In addition, once the CATO assets are commissioned, we are concerned that we may be exposed under our incentive package in the event that the final design progressed by the CATO does not maintain the security of supply currently afforded to our customers. We have previously discussed our concerns on this point with you but think further thinking is required as to how your proposals for CATOs interact with the arrangements in place for other regulated networks.

We also consider it is very important that the balance of risk between a CATO and adjoining DNO is not allowed to shift against the DNO as a means of the CATO submitting a low priced bid without this impact being fully recognised. For example, in relation to the North West Coast Connections project (“Moorside”), Ofgem decided in the RIIO-ED1 price review that the very significant diversion work of ENWL’s network should be funded as Directly Remunerated Services and accordingly that the cost risk sits with the TO. The form of contract to be signed between ENWL and a successful CATO is therefore assumed to be the standard for diversion work, effectively on a cost pass through basis.

It is our understanding that the dataroom for the project will contain an indicative, non binding, cost estimate for the work by ENWL to complete the required diversions and other expenditure. It will be for the CATO bidders to evaluate the robustness of these costs and the related risks and price their fixed priced bids accordingly. However, if in order to demonstrate a lower cost they change the basis of this risk allocation and related contractual terms then this needs to be recognised in Ofgem’s evaluation.

Ofgem should be mindful that any attempt to transfer risk to DNOs or other adjoining network operators outside of their respective price control terms by the CATO bidders is unlikely to be acceptable in isolation.

Evolution of Regulatory Framework

We understand Ofgem’s desire to attract alternative sources of finance for these projects and therefore the preference for a largely fixed 25-year package. However, we are concerned as to whether such rigidity will be appropriate during a period of increasing change within the sector.

We are working with your colleagues on some of the challenges presented by different frameworks for SO, TOs and DNOs, with Ofgem and through a number of ENA working groups. Learning from the work to date suggests that as the regulatory framework evolves and roles and responsibilities shift between industry players there needs to be mechanisms in place to respond to such change.

Different frameworks for different CATOs

We note the wording in the consultation document, particularly in chapter 3, which appears to suggest there could be significant differences in the regulatory frameworks between CATOs. The industry codes typically assign roles and responsibilities between parties on the basis of licence type. An approach whereby different licensees within the same class have differing obligations is likely to add an additional level of complexity for working relationships with CATOs. We believe it is important for other parties interacting with CATOs to be able to treat these as a largely homogenous group to assist in managing the interfaces effectively.

We welcome Ofgem’s comments regarding the treatment of CATO assets at the end of the 25-year revenue stream but would appreciate further information on how this will be managed.

We hope the above comments will be useful and would welcome engagement with you and the team, particularly in relation to the points raised above. In addition, if you have any comments or questions, please do not hesitate to contact myself or Jen Carter (jen.carter@enwl.co.uk).

Yours sincerely

Steve Cox
Engineering Director

Appendix 1: response to the Consultation Questions

Chapter One:

Q 1: How well aligned do you think the proposals in this document are with our objectives for onshore competition?

We can see the alignment between the proposals within the document and the overall objectives set out for onshore competition in electricity transmission. However, we are concerned that the level of detail available, whilst beyond that see previously, still struggles to address some of the specific challenges that the introduction of competition may mean for the wider sector.

In particular, whilst we recognise Ofgem's objective to ensure consumers are protected from undue costs and risks at a macro level, we are unconvinced that the full implications of these proposals where they interface with distribution are understood and there is therefore a potential risk that distribution customers may face additional future regional costs as a consequence of the implementation of these proposals.

Chapter Two:

Q 1: What do you think about our proposed approach to tender evaluation? Are any elements missing that we ought to look at?

Whilst we agree that cost should be given equal weight to other evaluation criteria, a number of these criteria are gateway criteria eg the technical specification. It is more usual to identify minimum criteria requirements as a pass / fail. Other criteria such as risk, cost and operational management tend to be comparative in nature.

Whilst we envisage that the overall network configuration will be determined by the DCO process, there is potential for several items of the final configuration to be changed post-award. We have consistently recommended that your acceptance criteria do not allow bidders to move from the submitted design, as it relates to other network licensees, without their explicit consent.

Additionally, the tender evaluation process needs to consider the proposed risk allocation between the TO bid and other adjoining network operators. If in order to demonstrate a lower cost the bidders change the basis of this risk allocation and related contractual terms then this needs to be recognised in Ofgem's evaluation.

Any attempt to simply transfer risk to DNOs or other adjoining network operators outside of their respective price control terms by the CATO bidders should be disallowed in the scoring mechanism.

Q 2: What are the main detailed aspects/criteria of our evaluation that you would like further clarity on as a priority over the next few months in order to inform your decision on whether or how to bid?

We think increased clarity on the obligations and potential revenue options for the CATO at the end of the initial 25-year period would be beneficial. Lack of clarity on this is likely to risk developers building lower cost assets that only last 25 years but renewal or replacement of these, especially where meshed into the network, may not be straightforward or viable at the end of the period. There is also the additional risk of stranding costs that are still incurred for the remainder of the asset(s)' statutory life which may present potential investors with challenges.

As described in our covering letter, we think there is merit in further work to consider what mechanism/s are required to update the regulatory framework for CATOs in the event of wider sectoral changes. Clarity on how such arrangements might work would be beneficial for all parties.

Q 3: What do you think about our proposals for variant bids? Which areas are likely to lead to the largest benefits for consumers? & Q 4: How could Ofgem best value the relative merits in variant bids of enhanced consumer outcomes, potential savings and likelihood of delivery where these do not align?

The widening of the market is intended to encourage greater innovation into the delivery of transmission solutions. Whilst we recognise it will introduce complexity into the tender assessment stage, we think there is merit in permitting bidders to include variant bids if they wish to. The nature of innovation makes it difficult to prescribe where advancements are likely to come so we recommend avoiding a fixed list of areas where such bids will be accepted. Instead, we propose a requirement on the bidder (should they wish to make a variant bid) to demonstrate why the proposed approach solves the problem identified in the Initial Needs Case and how this variant provide additional benefits to consumers.

Q 5: Do you consider that our proposed tender process stages and timings provide sufficient time for interaction with the supply chain and bidders to undertake required design work in order to put forward robust, fixed price bids at the ITT stage?

These seem necessary but will be very challenging for large projects. However, we are unclear how any costs incurred during the preliminary works phase that go beyond what is required to achieve planning consent will be treated. Whilst this is likely to be a transitory issue, it would increase certainty to all involved if this could be clarified.

One element that does lack clarity within this section is the extent to which bidders will be expected to engage with relevant DNOs. Whilst we anticipate this is likely to differ between projects, some clarity regarding expectations and the funding of the costs associated with this would be beneficial.

Q 6: Which contracts from preliminary works would you expect to be novated to the CATO on appointment?

The only contracts that we are in a position to comment on are those that we are party to so, in respect of work we undertake but is funded by the TO/SO, we do not expect this to be novated. Such distribution assets, albeit funded by a third party, we believe should remain with the DNO. Introducing embedded transmission assets will only increase the complexity of the regulatory framework and we do not believe will result in significant consumer benefits.

Chapter Three:

Q 1: What do you think about our proposed package of CATO incentives? Do you think we are missing anything?

The proposed incentive package, at the highest level, seems appropriate in light of current and historic experience. However, as highlighted in our covering letter, provision of appropriate mechanisms to revise and update in the event of significant industry change appear to be missing and we are concerned whether the proposal to fund solely from point of completion is introducing unnecessary risk to the framework, with consequential costs to consumers.

We are also concerned whether the incentives on availability and reliability will be sufficient to protect consumers' interests in the long term ie beyond the nominal 25 year period.

Q 2. What do you think about our proposals for the CATO availability incentive?

We support the inclusion of a strong incentivisation mechanism for availability and reliability and agree that it is important to keep the focus of this on reliability. As part of the development of this, we propose that consideration is given to the interaction with the Interruptions Incentive Scheme in distribution. In particular, we are unsure whether it remains appropriate for DNOs' customers to bear the risk associated with transmission faults, particularly where these are from new assets that the DNOs have limited or no opportunity to influence how these assets perform.

Given the uncertainties surrounding the evaluation process and proposals that a CATO may bring forward, we would recommend that the current interlinkage of DNO TO IIS incentive be removed for CATO systems.

Q 3: What do you think about our proposals for CATOs to participate in a Network Access Policy (NAP)? How do you think the NAP could best be managed to accommodate CATOs?

We welcome the proposals to include the CATOs with the NAP. With an increasing separation of the SO and TO within England and Wales, it may be appropriate for the NAP for England and Wales to follow the example of the Scottish approach or to adopt a GB-wide NAP that draws out the roles and responsibilities of the different licensed parties. It may also be appropriate to include OFTOs.

Q 4. What do you think about our proposed incentives for CATO asset management? Do you have any views on how we could best appraise asset health?

Given the concerns expressed about potential short-termism, we support Option 2 (revenue risk at end of term plus periodic condition reporting) as this will allow Ofgem to maintain a view on the CATO assets and to consider early intervention in the event that asset condition appears to be deteriorating sooner than expected.

We agree that the form of monitoring should be based on the NOMs Risk Methodology developed by the TOs as these cover the assets likely to be constructed by the CATO. This process may require supplementary technical review, particularly in respect of any assets constructed and operated by the CATO that do not form part of the scope of the TO NOMs Methodology at the time.

Q 5: What do you think about our proposed obligation for CATOs to fund new asset investment during the revenue term?

We believe it is essential that there is sufficient flexibility within the regime to accommodate wider industry change during the proposed revenue stream. All of the proposed options within the consultation documents will increase the level of risk borne by the CATO to some extent and may therefore result in additional, unnecessary cost, to consumers. A broader mechanism that deals with uncertainty may be more suitable, as it may more appropriately balance the risk between consumers and investors.

Any such obligation will also have implications for debt funding and depreciation. For example will any new asset investment also be depreciated over a fixed 25-year period or until the end of the original fixed revenue term? If the former then each new asset investment will effectively require inclusion within the anticipated future price review and the structure starts to look more like a conventional RIIO type arrangement. If the latter then the costs will have to be met over an ever decreasing term and this may store up problems for the future.

Q 6. What are the main considerations to ensure CATOs are financially robust, particularly during the construction period? & Q 7. What do you think about our proposal that CATOs should provide a construction security and have a credit rating during construction? How might this affect costs to consumers?

The financial robustness of the CATOs will be essential to ensure the successful delivery of the proposed projects and to provide confidence to the supply chain and other key stakeholders. Requiring CATOs to finance the entire construction period with no cashflow to offset any of the risk is likely to result in higher financing costs and increase the potential financial stresses on the CATOs.

We support Ofgem's view that it is important to have strong incentives to promote timely completion of projects but this may increase the risks to consumers beyond what it is intended. A milestone approach, with payment made on achievement of a number of clearly defined milestones, may be a more appropriate approach to balance the risks between parties.

The construction and operational period of the fixed revenue period clearly reflect quite different risks to lenders and this would be reflected in any credit rating assessment and ultimate debt pricing. The extent to which an investment grade is achievable for the construction period will depend on the equity / debt mix and the overall construction risks and final CATO terms. It may therefore have a cost impact when the bank and project finance markets may provide the short-term finance without a credit rating. However the expectation that the long-term profile is commensurate with investment grade and the obligation to achieve and maintain such a rating will be important to mitigate the refinancing risk of the short-term debt and so make this available.

We note that all the OFTO projects to date have been funded during the construction phase "on balance sheet" by generators and not by special purpose vehicles.

The principle of whether the CATO should only be funded when the construction phase is successfully completed has pros and cons as we acknowledge but it will also be important to provide clarity as to how and when the cash flow is turned on following such practical completion. Given the need for National Grid to forecast the Transmission Use of System charges to the electricity supply companies some time ahead, the process of how quickly the revenue stream starts and which entity carries the cash flow timing risk will be important to the financing arrangements.

Q 8. Do you have any views on our proposed CATO of last resort policy?

Appointment of a network operator of last resort (whatever the network type) is, and should be, an extreme intervention. Whilst the proposals contained within the consultation do not appear unreasonable, we consider it is not in consumers' interests for such a situation to be reached. To that end, a robust tender process to ensure that potential bidders have appropriate mitigations in place to minimise the potential for financial distress and regular monitoring of licensees by Ofgem to pre-empt the need for such a dire step are to be recommended.

Q 9: What do you think of the scope of proposed changes to industry codes and standards for CATOs that we set out in Appendix 4. What do you think would be the best mechanism for us to facilitate bidder market understanding of industry codes and standards (bearing in mind that Ofgem resourcing is limited and that there will always be a requirement for bidder due diligence)?

At a high level, we agree with the proposed changes in Appendix 4. Given that these codes are already able to deal with the differences between TOs and OFTOs, we anticipate the changes required being predominantly of a housekeeping nature, to introduce new definitions etc. However, this is subject to there being a single class of CATO licensee with a (predominantly) common regulatory framework. In the event of significant differences, this could make the process more complex.

Codes and relevant standards ie those linked to codes are freely (in the main) available on the code administrator web sites. Bidders are free to contact code administrators to assist in their understanding and can join code panels. (Many IDNOs have done so.) This is all

under open governance. Attaining this understanding is a part of market entry so we believe the costs incurred in gaining appropriate knowledge and understanding should be shouldered by potential bidders as part of their due diligence work.

Chapter Four:

Q 1: What do you think about our proposal to start CATO revenue on completion? Do you have any views on whether there would be benefit in allowing some revenue before completion for certain types of project, and if so, what should this be tied to?

See our response to Q7 in chapter three.

Q 2: What do you think about our proposal to align the depreciation period with the CATO revenue term?

We consider that this decision is linked to the response at Q5 in chapter three about future asset investment and the arrangements following the end of the revenue term.

It also links to the proposed financing arrangements since the CATO would need to repay the original construction debt over the depreciation period as it will have no guarantee of revenue beyond this term, although it will still own the asset.

Q 3: Do you have any views on our proposals for arrangements at the end of the revenue term?

Whilst we appreciate Ofgem's challenges in terms of setting out what may happen at the end of the revenue term, we do believe it is important to provide certainty for the wider sector as to what will happen at the end of the revenue term. We therefore support the recommendation that CATOs continue to own and operate the assets at the end of the period and would welcome further information on this approach.

Q 4: Do you have any views on our proposed debt refinancing sharing arrangements?

This is really for potential CATO bidders to respond but we observe that although the expectation is that the construction period debt can be refinanced at a lower credit price this still leaves the CATO exposed to market rate risk and a "gain no pain" share mechanism will require the bidders to price in this risk to required equity returns over the life of the project.

A mechanism that seeks to share any out-performance of forecast credit risk but also adjusts for market rate risk in the short-term between bid and refinance would seem to provide the maximum benefit to consumers.

Q 5: What do you think about our proposal to include a mechanism to capture some of the benefit of a CATO equity sale? What impact do you think it would have on the cost of capital bid during the tender?

We consider this is matter for potential bidders to respond but we observe that placing all the construction funding risk with bidders, removing any material debt refinancing upside and capping any equity upside may indeed have an unnecessarily negative impact on the required cost of capital.

Q 6: What do you think about our proposed risk allocation for CATOs? How do you think we can best mitigate and/or allocate risks associated with preliminary works?

At the high level set out in the consultation document, we support the proposed risk allocation. It is our view that licensees should bear risk where they are best placed to manage it.

In relation to the risks associated with preliminary works, consideration needs to be given as to the parties involved in delivering preliminary works and their interaction with the tender process. We would certainly expect to deliver any works we are involved in to a recognised industry standard.

However, it should be recognised that these are likely to be ancillary to our core activities and we are concerned that extensive due diligence by multiple potential bidders could create significant distraction from delivering on our commitments to our customers in the North West. An appropriate balance therefore needs to be struck in terms of preliminary works.