

Gordon Hutcheson
Senior Manager
Transmission Competition Policy - Ofgem
9 Millbank
London
SW1P 3GE

29 September 2016

Dear Gordon,

Extending Competition in Electricity Transmission: Tender Models and Market Offering

Scottish Hydro Electric Transmission plc (SHE Transmission) welcomes the opportunity to respond to Ofgem's latest consultation on extending competition in electricity transmission. In particular we appreciate the greater clarity in the tender process, and the comprehensive framework being consulted around CATO's regulated revenue. We also welcome the efforts to align the CATO's incentives and obligations with those currently applying to TOs, as we think this will allow a smoother integration between the different models.

Notwithstanding this, we continue to have some concerns. In our view, further and detailed regulatory development is still required in several areas, namely preliminary works risk allocation, CATO incentives and obligation related to asset management and additional investments, end of revenue term arrangements, CATO's financial structure and financial ring-fencing, and the procedure for appointing a CATO of last resort. These are summarised below and explained further in the Appendices to this letter:

- We remain concerned about the feasibility of the proposed timetable to introduce competition in electricity transmission. Considering the need to substantively review the regulatory framework and the limited number of Strategic Wider Works projects likely to be available to competition in RIIO-T1, we believe the timescales should be refocused to aim to introduce both competition models (early and late) from RIIO-T2.
- We are proposing additional elements to be considered in the evaluation methodology and the inclusion, in the project timescale, of additional phases after the tender to the preliminary works handover process.
- In our view, the ITT stage will require a longer period than that estimated in the consultation, due to the requirements to provide a detailed design and engage with the supply chain.

- We also believe that greater clarity is required, ahead of the tender, about some of the CATO's obligations and incentives, in order to give to the bidder a good understanding of the framework that will be applied during the revenue term and beyond, for example, about asset management and additional investments obligations.
- We encourage Ofgem to adopt a more flexible approach with regard to the commencement of the revenue term, whereby revenue could be earned during construction on the grounds of financeability and optimising financing arrangements.
- The CATO of last resort policy also needs substantial development and reconsideration by Ofgem to ensure it is capable of practical implementation if required.
- We agree with the proposal that assets owned by the CATO would remain the property of the CATO at the end of the revenue term. However, more information is required, before running the tender process, regarding what form of price control would be introduced at the end of the revenue term.
- Proposals regarding the regulated revenue and its financial aspects should be refined in order to set up an attractive market offering and to guarantee a level playing field between bidders and also between CATOs and TOs.
- We remain concerned about the risk allocation of the preliminary works, as the TO's liabilities at this stage are not clear.

Appendix 1 expands on these points and Appendix 2 contains our response to the consultation questions.

SSE remains cautiously supportive of the concept of extending competition to onshore transmission assets. Although progress has been made through previous consultations and a series of expert working groups, there is significant work still required to develop a detailed, robust and workable framework for competition.

We are happy to discuss the above and our response to the consultation questions further, and look forward to working with all interested parties as the competitive delivery framework is developed.

Yours sincerely,

Leticia Pelizan
Senior Regulation Analyst
(leticia.pelizan@sse.com)

APPENDIX 1 - DETAILED RESPONSE

Introduction

In so far that the development of the regulatory framework has progressed through consultations and working groups, in our view it is becoming increasingly clear that the timetable for implementation needs to be reconsidered. The size and the nature of the electricity transmission development requires a careful and detailed regulatory design, in order to mitigate the risks associated with the introduction of competition and ultimately to deliver the expected benefits to customers. We believe that the detailed nature of future consultations will require longer workgroup sessions, significant internal resource from both industry and Ofgem, and extended consultation times.

In our view, the framework of the proposal is taking account of the right elements to meet the objectives described in Chapter 1 of the consultation. However, we believe that further discussion and development is required in several areas to ensure that bids are robust, deliverable and do not place undue risk onto the customer, that the CATO is taking the right amount of risk and that the financial structure is appropriate. We believe that more detailed consideration is needed regarding preliminary works risk allocation, asset management and additional investments obligation, end of revenue term arrangements, the CATO's financial structure and CATO of last resort.

With this in mind, and given the limited number of RIIO-T1 projects likely to be available for competition, we would suggest that Ofgem, with the industry, reviews the programme for the development of competition. We believe the focus should be on ensuring that both the early and late CATO models are sufficiently developed and the regulatory framework in place and available for the start of RIIO-T2.

Late CATO build Tender model

We support the proposal to run the tender in a 3 stage process, and that the ITT stage should start once the planning consent is in place. We also agree that the timing to decide when to commence the tender process should be determined on a project by project basis.

With regard to the evaluation methodology proposed, we believe it is not considering all relevant elements that impact on customers. We offer more details of this in our response to question 1 of Chapter 2.

We also have concerns about the timescale assigned for the ITT stage, as complex projects will probably require bidders to have a longer period to provide a detailed design and then competitively issue tenders to their supply chain (see our response to question 5 of chapter 2).

We suggest that there are two stages omitted from the process proposed to date, those being: 1) a period for the formal handover of the preliminary works from TOs to CATOs and to transfer, for example, the consents, wayleaves, land agreements and 2) a timescale for the preferred bidder to resolve any matters determined by the Authority before it becomes the successful bidder, in a similar process to that utilized in the OFTO's enduring regime.

CATO obligations and incentives

We appreciate the efforts to implement a set of CATO incentives and obligations that are compatible and aligned with those currently applicable to the TOs, as in our view this is essential to mitigate the risk of different behaviours and responses, to allow comparisons of the models and the licensees outputs, and to guarantee a level playing field. We also support the proposal that the CATOs should be subject to the same requirements to invest and to allow new connections as TOs and that financing arrangements that suit CATOs should not distort or frustrate appropriate co-ordinated evolution of the transmission system.

Although the approach to incentives and obligations appears reasonable, we believe more detail is required to develop the asset management and new asset investment obligations for the CATOs, alongside the end of revenue term arrangements. We address this question in more detail in our response to the Chapter 3 questions.

The CATO of last resort policy also needs some reconsideration and further development to ensure it is capable of practical implementation if such an event occurs. For example, it is unclear what process, timing and obligations would be in place or how Ofgem would facilitate this commercial transition when most likely it would have little to no control following the financial failure of the CATO. The process is currently undefined and its development should be a priority for Ofgem over the coming period as it will impact on the risk profile of CATOs with consequential impact on customers.

CATO regulated revenue

We encourage Ofgem to adopt a more flexible approach with regard to the commencement of the revenue term, whereby revenue could be earned during construction on the grounds of financeability and optimising financing arrangements. The expectation that CATOs will be able to finance construction while receiving no revenue through the full construction term will not be practical in all circumstances.

We agree with the proposal that assets owned by the CATO would remain the property of the CATO at the end of the revenue term. However, more information is required regarding what form of price control would be introduced at the end of the revenue term, even at a high level, in order to reduce bidders adding a risk premium.

We also believe that it is appropriate to align the depreciation period with the CATO revenue term. However, the length of the term means that the CATO would have a fully depreciated asset which would likely still be in use. This is not generally the way in which depreciation should operate as the asset should be depreciated over its useful life, and more development is needed to address the problems arising from this misalignment, as we outline in our response to question 2 of Chapter 4.

With regard to the risk allocation arrangements, we appreciate the responsibility of CATOs to undertake effective due diligence and manage risk. However, we remain concerned about the uncertainties around the preliminary works' risk allocation. In order to accommodate bidders' and TOs' expectations, more details are still required around liabilities, quality and standards of work carried out. In our view, after the tender, in the handover process, all responsibilities and liabilities linked to the preliminary works should transfer to the successful bidder. In the event that later, for example in the construction phase, unforeseen preliminary works issues arise, the CATO could be entitled to recover costs through re-openers instead of pursuing an indemnity claim against the TO or the preliminary works contractor. The TOs responsibilities for the preliminary works after the tender should be limited to exceptional circumstances. i.e. where the TO has been negligent. We develop our views in this matter in more detail in our response to question 6 of Chapter 4. The development of this matter, along with the definitions around the handover process, should be a priority for Ofgem over the coming period, especially considering that it must be concluded before further development of the TO's licence conditions change proposals.

APPENDIX 2 - SHE TRANSMISSION RESPONSE TO CONSULTATION QUESTIONS

CHAPTER 1 – Introduction

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

Overall, we believe the framework of the proposal is taking into account the right elements to meet the objectives described in Chapter 1 of the consultation. However, we believe that further discussion and regulatory development is required to ensure that the competitive process is robust, that projects are deliverable and the process does not place undue risk onto the consumer, particularly in relation to the preliminary works risk allocation, asset management and additional investments obligation, end of revenue term arrangements, financial ring-fencing and appointment of a CATO of last resort. Our concerns in each of these areas are explained within this response, all of them need more detailed regulatory development.

Question 2: What do you think are the implications of our overall proposed policy around the tender process, CATO incentives and obligations on CATO cost of capital and levels of competition for a CATO licence?

In our view, the framework developed so far, alongside the uncertainties/lack of definition in certain areas, brings more risk to the CATO and to customers than those that exist in the RIIO model. This could be reflected through a higher cost of capital. We are confident that these issues can be addressed before the first tender is issued, but this could require more time than initially estimated.

CHAPTER 2 –Late CATO build model

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

It is critical that the evaluation methodology considers all relevant elements that impact on customers. For example, the impact of enhanced asset lives, of plant that provides other benefits, outages and constraints, are key to the evaluation of a tender. If the evaluation methodology fails to include these elements it will be contradictory to the current RIIO approach and it will not adequately consider all critical aspects of each tender bid. The methodology for evaluation of CATO bids needs to be developed, defined and consulted upon by Ofgem to ensure it is robust and inclusive of critical elements.

Regarding the equipment/assets characteristics to be used by the CATO, we do not agree that the existing standards will be sufficient to ensure the CATO's equipment is designed, procured and

constructed to ensure efficient networks operation. Some of the industry standards only define the quality and the characteristics of the equipment in terms of minimum requirements. Once the minimum requirements are met, the different decisions that each bidder could make about equipment lifespan and reliability could impact on the final benefit realised by the customer. Therefore, this should be assessed through the evaluation of the different proposals.

In the early development phase of projects, network configuration and sequence of build are considered as part of the overall design. This is of particular importance where there are network constraints or reduced security circuits. In the late model, the SO will have to take a view on the build sequence, in the evaluation stage, and ensure this is taken into account in the overall design. Moreover, during construction, the CATO will have to balance the security of the network, with impacts on customers and generators during system outages. There will need to be clear accountability for decision making as to what optimum solution is agreed and deployed taking these factors into account. We believe that these factors should be included in information required and evaluated at the ITT stage.

Furthermore, requiring that all bidders carry out detailed design at the ITT stage is likely to be a costly exercise. We suggest defining the expectations regarding detailed design on a project by project basis.

Question 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?

Since the Tender Revenue Stream or costs of any tender bid will form 50% of the assessment score, it is critical this methodology is developed as a priority. This informs 100% of all bids and should be considered part of the critical path to deliver a well defined and understood ECIT model. Also, indexation would need to be assessed on a consistent and comparable basis if they differed across bids. This would require some form of forecasting of indexation by bidders and Ofgem would need to consider how these proposals could be objectively assessed. We believe it would be more appropriate that the indexation approach is proposed by Ofgem on the basis of existing RIIO arrangements.

Question 3: What do you think about our proposals for variant bids? Which areas are likely to lead to the largest benefits for consumers?

Potentially, any variant bids could bring certain levels of innovation to optimise the final solution. However it will be largely dependant of the flexibility on the terms of the planning or Section 37 consent, including constraints (outages, noise, connection end dates, overhead line routes, substation development boundaries). In our view, the flexibility within the current consenting process is limited due to the requirements of the Environmental Impact Assessment process. Furthermore, variant bids require more time to be developed and could potentially be more complex and time consuming to evaluate. As such, in the late CATO model the opportunity for

innovation or project changes is likely to be limited, limiting the potential to generate benefits for customers.

Finally, we would suggest that where variant bids are submitted, a compliant bid should still be required from each tenderer to allow a direct comparison of costs, programme and risk.

Question 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?

In the case that variant bids are implemented, a compliant bid should be required from each tenderer to allow a direct comparison of costs, programme and risk. The variant bids should be assessed in line with a similar methodology to non-variant bids, i.e. a CBA type approach. The weighting of each criteria should be stipulated on a project by project basis, to give an indication to bidders about the most important elements of the project.

Question 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?

The suitability of the timescale for the identified elements depends on the type and complexity of the project. Although the timing estimated seems reasonable based on relatively straight forward projects, for more complex projects a longer period will likely be required for the ITT stage, to provide a detailed design and subsequently competitively issue tenders to the supply chain. The model process dictates that the supply chain will have to engage with multiple parties during the procurement process. In our experience when negotiating with the supply chain this could take a 4-9 months period, depending on the complexity of the project. There is also a risk that there is no appetite to engage in multiple tenders or that the supply chain seeks recovery of additional tendering costs. There are alternatives to partially solving this problem, by having prior agreements with the supply chain regarding rates and risk allocation. However, this will limit the opportunities to drive down competitively tendered costs and restrict more detailed design alternatives.

The timing also depends on the quality of information in the data room and whether the bidders are comfortable with the data available and its associated risks, or if after the due diligence they prefer to carry out surveys/investigations themselves.

We suggest that there are two stages omitted from the process proposed to date, those being: 1) a period for the formal handover of the preliminary works from TOs to CATOs (to transfer, for example, the consents, wayleaves, land agreements) and 2) a timescale for the preferred bidder to resolve any matters determined by the Authority before it becomes the successful bidder, in a similar process to that utilized in the OFTO's enduring regime.



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

The contracts related to the land rights, as land agreements and wayleaves are more likely to need a novation or legal transfer process. In general, we expect that most of the other contracts (e.g. contractors and consultancy firms) will not be novated to the CATO, as all services should be complete during the preliminary works stage and prior to ITT. In our view, instead of transferring the contracts related to preliminary works, all reports and data gathered during the preliminary works stage will be available in the data room for any potential bidders to assess. A detailed assessment about which contracts, liabilities or third parties guarantees should and could be transferred to the successful bidder will be needed on a project by project basis, prior the ITT stage.

Question 7: What are your views on the potential value, and practical implications, of a share sale model for tendered RIIO-T2 projects?

There is a lack of clarity on the benefits of this type of approach or how it would work in practice. More detail is required prior to the formation of any formal opinion. Our preliminary view is that this model will be more challenging to implement than the asset sale model and will require more legal development.

Question 8: Based on your understanding of the HVDC supply market, what are the priority areas we should be looking to consider over the next few months in order to ensure HVDC projects can be tendered efficiently under late CATO build?

We are not clear on why there would be a need to differentiate the HVDC projects tender process.

As we noted in our response to the October/2015 consultation, the early procurement of the converter station design may restrict the competition in cable design as the two aspects are heavily inter-related. While there is evidence to suggest they can be tendered separately, our experience suggests retaining an option for tendering both together. Allowing the market to determine an optimal design solution may open up what is already a constrained market; maintaining the procurement options could drive a more efficient solution.

A key consideration for HVDC systems is the assessment of designs for system integration e.g. the effect of harmonics. The responsibilities for design and compliance need to be clearly set out and understood. This can often be an iterative process, with filter requirements and designs changing and requiring tuning right up to and during commissioning. Who takes liability for background levels and for resolution if a long term problem is discovered requiring remedial intervention? The responsible party will also have to ensure details of any affected generators are taken onto account during the design phase. The potential impact on neighbouring networks will have to be assessed and the ongoing changes to the actual real-time system make it difficult to assess on a modelled basis. The SO, or existing TO, is probably best placed to assess and consider these

aspects. However, the CATO will have a role to play during detailed design and commissioning. In the proposed late model, the SO may have to take this on in the event of the suggested early procurement of HVDC components prior to tendering for the build. This may be an influencing factor in determination of the optimum procurement strategy.

CHAPTER 3 – CATO obligations and incentives

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

As noted in our responses to previous consultations, we support the idea to implement CATOs obligations and incentives similar to those applied to the TOs. Considering the different nature of the RIIO price control and the 25 year Tender Revenue Stream methodologies, we believe that it will be challenging to assure that all onshore transmission owners' (TO or CATO) incentives are not only compatible but also aligned. Even so, in our view it is essential to mitigate the risk of different behaviours and responses, to give the Authority the ability to compare the models and the licensees' outputs, and to guarantee a level playing field. Commercial behaviours cannot be allowed to take precedent over system requirements as this has the potential to adversely impact security of supply.

We also agree that it may be appropriate to establish a baseline CATO incentives model and to allow variations depending on the project, instead of a "one size-fits all" approach. These variations however should not give space for implementing a discriminatory set of rules or drive behaviours which are not aligned with the safe, economic and efficient operation of the Main Interconnected Transmission System.

Although the overall approach to incentives and obligations appears reasonable, we believe that it is important to determine upfront (before the tender) the asset management and new asset investment obligations for CATOs, alongside the end of revenue term arrangements, with some level of detail. The present lack of clarity, before the tender stage, about the responsibilities required of the CATO during and after revenue term will bring uncertainty to TOs and CATOs, could impact directly on bids and undermine the expected outcome of the competitive process. In our view, a Tender Revenue Stream model requires a different and higher level of clarity/firmness alongside regulatory decisions with a long-term impact, when compared with the RIIO model approach. This is a downside of the model that the Authority needs to consider when determining the market offering. In our view, this requires significant further development before a tender could be run.

We also believe that a Stakeholder Satisfaction incentive should be included in the CATO baseline, to ensure customers are treated alike regardless of owner and operator of assets within regions. For the CATOs who will not interact with a large number of stakeholders, the weight/size of the incentive could be adjusted.

Finally, we suggest to keep the incentive methodology as simple as possible, to allow all bidders to assess them in an easy and consistent way, and also to facilitate comparison between licensees.

Question 2: What do you think about our proposals for the CATO availability incentive?

These proposals appear reasonable although we would highlight the area of uncapped penalties as these can roll forward if the annual cap has been reached. This appears overly penal and should be reviewed for appropriateness by Ofgem as otherwise this may make the market unattractive to new bidders. Additionally, it is necessary to consider the impact of unforeseen events on incentives and penalties and whether the design of an incentive framework inadvertently creates sizeable liabilities and hence increases the risk of CATO bids. This could either dis-incentivise participants in the process or push up the cost of bids to accommodate the level of risk. There is no clear reason or justification as to why similar incentive arrangements to RIIO could not help to achieve desired network performance.

Question 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 support this proposal, as we think the NAP can drive a more efficient management of outages and availability. In our view, a standard approach applied equally for all TOs and CATOs would be more appropriate to accommodate a larger number of participants. We believe that the NAP should be extended and developed to guide the interactions between TOs and CATOs.

Question 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?

In our view, asset health assessments should be undertaken regularly as with current RIIO arrangements. Notwithstanding, further development of the principles for CATO asset managements are required, in order to guarantee that CATOs will build and operate their network to assure long-term asset health while considering the customer's best interest. It is important to assess and solve the implications of using a model where the relatively short revenue period (25 years) is not aligned with the assets optimal life (40 years for some equipment). We refer further on this issue in our response to the question 2 of Chapter 4, below.

Also, as noted in our response to question 1 of this same chapter, it is necessary to bring clarity to the definition about the operation of this incentive prior to the tender.

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

We believe that CATOs should be subject to the same requirements to invest and allow new connections as TOs and the financing arrangements that suit CATOs should not distort or frustrate co-ordinated evolution of the transmission system. Therefore we support the proposal that any

investment that is not subject to competition should be the responsibility of the CATO (option 3 on page 48 of the consultation). Further development is required, in terms of expected returns, on how to fund and to assess the costs of the additional investment and how to incorporate it in the Tender Revenue Stream. These definitions should reduce the uncertainties that the CATO will face. The balance of risk and cost needs to be considered by Ofgem and the definition of pre-defined uncertain events needs to truly capture those circumstances where the events are outwith the CATOs control, for example, the changes in network usage and demand requiring further reinforcement in 20 years.

Question 6: What are the main considerations to ensure CATOs are financially robust, particularly during the construction period?

There should be minimum gearing ratios and, in particular, a focus on encouraging the maintenance of investment grade credit ratings. Additionally, as outlined in our Chapter 4 responses, revenue should be allowable during the construction period as there is a strong enough incentive to deliver projects on time for CATOs if they have similar obligations to incumbent TOs.

Question 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 need for a construction security is only necessary on the basis that revenue is earned during construction in order to protect consumers. The tender process should be robust enough to mitigate the risk of CATOs with an unproven track record undertaking substantial and risky projects on behalf of customers. As such, the need to maintain credit rating metrics for an investment grade rating should be a minimum requirement as well as the provision of annual statements or certifications confirming the Availability of Resources, as required under incumbent TOs licence obligations. This would be in addition to ring-fencing arrangements and restriction of cross subsidisation.

Question 8: Do you have any views on our proposed CATO of last resort policy?

The CATO of last resort policy also needs some reconsideration and further development to ensure it is capable of practical implementation if such an event occurs. It is unclear what process, timing and obligations would be in place or how Ofgem would facilitate this commercial transition when most likely it would have little to no control over the CATO in a situation most likely to have been brought about following the financial failure of the CATO. The process is significantly undefined and its development should be a priority for Ofgem over the coming period as it will impact on the risk profile of CATOs with consequential impact on customers.

The current proposals give an option for the incumbent TO to take over for a period until a tender process is conducted. This could result in a number of different CATOs being involved in the same project, which could lead to inefficiencies in completion of the project and additional cost to

customers. The CATO of last resort policy should also cover the potential cases of CATO's exit/failure after the period of construction and after the end of the revenue term.

Question 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)?

We believe that, as a principle, CATOs should be subject to the same codes and standards as TOs. Bearing this in mind, the scope of the proposed changes seems comprehensive and in accordance with industry codes currently applied for the TOs. We believe that the industry group dealing with the revision of the industry codes will require multiple sessions on this aspect. In our view, CATOs should be required to meet the technical interface standards of whichever TO network they are embedded, in order to ensure the safe and co-ordinated operation of the transmission system.

CHAPTER 4 – CATO regulated revenue

Question 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?

We recognise that Ofgem are seeking to enhance the incentive strength for CATOs to deliver projects on time. However, we encourage Ofgem to adopt a more flexible approach, whereby revenue could be earned during construction to allow for optimising financing arrangements. The expectation that CATOs will be able to finance construction while receiving no revenue through the full construction term is not practical.

This proposal may hinder the competitive nature of the CATO market as the timing of revenue may discourage entrants to the market. Smaller bidders may not consider these arrangements practical, particularly in terms of financeability. It would therefore not be appropriate to assess bids simply on the timing of CATO revenue, and other factors should be considered, such as benefits and the counterfactual of delaying revenue.

There is a strong enough incentive on existing TOs, who receive revenue during construction, to deliver on time due to regulatory obligations and ring-fencing arrangements. There is the option that the CATO could provide a financial guarantee via a third party organisation equal to the value (or proportion) of revenue received during construction if this was deemed a risk. It is our view that the most flexible approach for the timing of revenue would be to allow CATOs to build such timing into their bids. This would allow CATOs to bid for the receipt of revenue during construction as long as adequate protections were in place.

The current proposal could cause undue pressure on the finances of CATOs, which may drive unsafe working practices should CATOs cut corners in order to complete construction on time. With a revenue stream during construction, this risk could be lessened.

We therefore believe that there would be benefit in allowing some revenue before completion but do not believe that there should be a policy applied in relation to the timing of revenue (except for adequate consumer protection); this should instead be the decision of the bidding party. We believe that CATOs should have investment grade metrics and earning revenue during construction would make this more achievable, therefore encouraging new entrants.

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

We believe that it is appropriate to align the depreciation period with the CATO revenue term. However, the length of the term means that the CATO would have a fully depreciated asset which would likely still be in use. This is not generally the way in which depreciation operates as the asset should be depreciated over its useful life. The RIIO price controls have shown that assets have useful lives of around 45 years. This could potentially leave a remaining useful life of 20 years on CATO assets, with no associated value being held relating to these assets. There will be a misalignment between the technical useful life of assets and the charging period which is inconsistent with the RIIO price controls and seems at odds with the BGT appeal to the CMA which encouraged Ofgem to revisit and justify the appropriate charging period for assets.

It is our understanding that the 25 year revenue term may lead to inter-generational issues between customer groups, as customers in later years will receive the benefits of assets which they are not being charged for. Customers in the 25 year charging period will potentially be overpaying for the use of these assets. We do not see adequate justification or evidence for this charging period and it contradicts previous decisions, evidence and justifications. We would ask Ofgem to clarify its position with the use of such evidence and justification to create certainty for CATOs regarding this proposal.

The asset life and revenue term may dis-incentivise CATOs from continuing to hold CATO assets at the end of the 25 year term as they would incur the costs of maintaining the asset while having no or little associated revenue. Due to uncertainty around what happens at the end of the CATO revenue term, this proposal may inadvertently encourage exits at that time. There is therefore a need for a further policy in terms of arrangements at the end of the revenue term should the original CATO decide to dispose of the asset at the end of the 25 years. This should be addressed by way of a policy prior to the start of any competitive tender process. There is also a strong concern that if an asset's useful life matches the revenue term, then the bids which utilise more expensive assets, lasting longer than 25 years, would be disadvantaged and this may not be in the best interest of customers. Ofgem needs to establish how it will assess the technical life of assets where they are materially different to one another. The benefits as well as the costs/revenue of

all bids need to be considered and such an evaluation methodology is not clear within the consultation document.

Secondary to this, the statutory financial position would lead to either an accelerated depreciation policy on assets with a longer useful life or impairment of these assets throughout the revenue term. This seems at odds with generally accepted accounting principles.

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

We agree with the proposal that assets owned by the CATO would remain the property of the CATO at the end of the revenue term. We also agree that there should be criteria for tendering so that tendering is not the default position at the end of the revenue term. However, more information is required regarding what form of price control would be introduced at the end of the revenue term, whether the CATO has the right to exit the arrangement after the 25 years period and the timings and process to define and agree the details of the arrangements. We are unable to comment on the appropriateness of the price control given the limited information given in the consultation on what this would comprise. The price control would need to be such that it would encourage CATOs to retain the assets following the completion of the revenue term as otherwise, this would leave it open to CATOs to exit the market at the end of the term. In particular, smaller CATOs who hold fewer assets may not be attracted to maintain the assets if the price control does not allow for adequate operation and maintenance costs and adequate return on maintaining these assets. The obligation to maintain the asset after the 25 year term requires further definition alongside any incentives introduced to encourage this behaviour (as outlined in question 2 above).

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

We appreciate that the current proposal is to encourage efficient debt financing. However, the proposed arrangements are asymmetric given that market conditions can move both up and down. Therefore, some form of benchmark or index would be more appropriate in terms of assessing company performance in order to make the arrangement fairer. This would be similar to the current arrangements under RIIO. Secondly, when a CATO is successful in its bid, the Tender Revenue Stream is reflective of what it sees as its financing costs as well as the capital and operating costs. In the event that further savings are available due to efficient financing, then we believe this should be to the benefit of the CATO. Customers will have already benefited from the outcome of the competitive process and should not then benefit from any upside on financing but should be shielded from any downside of market risks.

The sharing mechanism is stated as only applying to externally provided debt. We would require confirmation of what this would mean for any internal debt funding as CATOs may choose to arrange funding via a parent entity in order to be more efficiently financed rather than through external funding. Should CATOs choose to do this, while providing both evidence of market pricing

and that the relevant back-to-back arrangements are in place, there would be no cross-subsidy in line with existing TO regulatory obligations. We believe that arrangements would be adequate.

On a separate note, we would like further information on Ofgem's proposed treatment of tax arrangements of a bidding CATO. Ofgem should outline how it will assess/monitor the impact of a lower Tender Revenue Stream as proposed by a CATO due to a lowering of their taxation costs, given the adverse impact on customers via the impact on HMRC taxation receipts. We believe a fairer taxation evaluation will eliminate a bias in the bid assessment process, which may obscure the most appropriate bid.

Question 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?

In principle, we agree that this is an important mechanism for driving long-term behaviour of participants. It may avoid CATO's bidding to construct an asset with an early exit while securing some form of return, when the operating risks are passed to another party. However, more certainty is required around the 'pre-defined percentage' which would be applied to the revenue stream. An understanding of how this percentage would be set and whether it should instead be driven by the gain achieved would be required in order to comment on the suitability of the pre-defined nature of the percentage. More fundamentally, we believe a justification of why this is necessary and what benefits this may yield for customers is required since this has not been made clear in the consultation document.

With regards to the impact on the cost of capital a CATO would bid, this is unknown without further work and analysis, although ultimately it reduces the liquidity of this type of asset which may inadvertently increase the cost of capital. It may be more appropriate to have licence restrictions on changes in ownership and a need for Ofgem approval.

Question 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?

We appreciate the responsibility of CATOs to undertake effective due diligence and manage risk. However, we remain concerned about the uncertainties around the preliminary works' risk allocation. In our view, clarity on these arrangements is one of the key challenges of the late CATO model. The interface between CATO/TO liabilities is currently an intrinsic problem of the model. In order to accommodate bidders' and TOs' expectations, more detail is required around liabilities, quality and the standard of work carried out. In particular, this is required for RIIO-T1 projects where TOs have been funded to develop the pre-construction works for projects already being executed. It is important to understand the responsibilities of each party and who deals with any issues associated with transfer. We believe that, once the data room is populated, the suitability/quality of the information should be assessed by Ofgem (through the assessment to determine if the tender can be run) and by the bidders (through the due diligence process). After the tender, in the handover process, all the responsibilities and liabilities linked to the preliminary

works should transfer to the successful bidder. In the event that later, for example in the construction phase, unforeseen preliminary works issues arise, the CATO could be entitled to recover costs through a re-opener mechanism instead of through the TO paying any kind of indemnity to the CATO. The TO's responsibilities for the preliminary works after the tender should be limited to exceptional circumstances i.e. where the TO has been negligent.

In relation to the risks associated with preliminary works, specific criteria could be introduced regarding the due diligence process, effectively acting as an appropriate programme for proper due diligence and reasonable timescales. Therefore, if there are additional costs which arise over and above what the original bid estimated, re-openers can be considered, provided that sufficient due diligence had been carried out. Areas where material risks are unknown and cannot be determined based on the work done at the due diligence stage arrangements should be considered for re-openers, to encourage participants and general innovation in CATO bids.

We would also advocate that Ofgem ensures sufficient time is allocated to allow proper due diligence on all material aspects of a project, in particular those areas where the risks are more significant. We also agree that there should be mechanisms to adjust for unforeseen events. However, more information is required from Ofgem on the range of specific pre-defined events. The 'general policy on CATO risk' would also need to be reviewed in order to ensure that risks not covered by 'mechanisms to adjust for unknown events beyond a CATO's control' are reasonable. There should be scope for re-openers where costs arise which were not foreseeable such as when Network usage and demand changes, resulting in a material change in the CATO assets. In the absence of some form of uncertainty mechanism, there may be a dis-incentive to bid or an increase in the bids to cover the uncertain costs. Therefore restrictions on the situations where re-openers are allowable may discourage competition and have an adverse impact on the objectives of ECIT.