DALMORE CAPITAL

EXTENDING COMPETITION IN ELECTRICITY TRANSMISSION: TENDER MODELS AND MARKET OFFERING

29 SEPTEMBER 2016

1. Executive Summary

Dalmore Capital Limited ("Dalmore") welcomes the opportunity to formally respond to Ofgem's recent consultation, 'Extending Competition in Electricity Transmission: Tender Models and Market Offering'.

Dalmore was established in 2009 with the aim of becoming a leading player in the UK core infrastructure sector. We believe the proposed Competitively Auctioned Transmission Owner ("CATO") regime represents an attractive new opportunity for long term UK infrastructure investment, and is one that can deliver significant savings to the consumer in a similar vein to those delivered to-date through the Offshore Transmission Owner ("OFTO") regime.

Dalmore is enthusiastic about the opportunity to participate in the upcoming offering. We are currently raising a new investment fund for long-term investors with considerable appetite for deploying capital into UK infrastructure with the potential CATO investment opportunity earmarked as a core investment area. It is an opportunity that we feel our experience and expertise is well aligned with, and one in which we can deliver value through the development and delivery of innovative approaches and best in-practice operations.

Dalmore is experienced and familiar with the energy transmission sector and the industry regulator, Ofgem, through our existing OFTO[1], and it is a sector in which we intend to participate in the foreseeable future. Our active management approach is based on achieving best value for the consumer, namely the efficient delivery of new assets to cost and programme, and the best use of facilities in operation. To this end Dalmore aims to build and maintain strong working relationships with clients and regulators.

UK core infrastructure has long attracted institutional investors due to the many positive, and generally homogenous, characteristics of the assets. Dalmore, through our predominantly UK pension fund investor base, is seeking to take part in the potential opportunities to invest in the transmission sector. We believe CATOs will exhibit many qualities that appeal to our long-term, low risk investor base, including:

- Long established and stable regulator;
- Opportunity to deploy significant capital;
- Long-term investment horizon;
- Low volatility inflation-linked yield; and
- Liability matching opportunity for pension fund investors.

[1] West of Duddon Sands

2. Dalmore Overview

Dalmore focuses on investment in low-volatility infrastructure assets in the UK and is a leading manager in this sector. Dalmore currently manages in excess of £1.7bn for institutional investors across ten funds, co-investment accounts and single account mandates.

Dalmore has developed an emphasis on contracted and other low risk infrastructure assets. Such assets have predictable income streams and provide strong risk-adjusted returns with limited volatility. As such, Dalmore has been a key conduit for pension capital to gain access to significant infrastructure assets. This has included forming the consortium that was successful in winning the Thames Tideway 'super-sewer' in London in 2015 and it is now an established investor in UK regulated infrastructure.

As an independent fund management business with a sole focus on infrastructure, Dalmore has developed a business model that utilises its significant investment team (with over 300 years of collective infrastructure experience) to generate investment propositions that provide robust returns for investors. Dalmore's team comprises 35 individuals across two UK offices, and includes 26 investment professionals.

As Dalmore has grown, it remains concentrated on developing investment opportunities in low volatility infrastructure assets, including those under long-term availability-based revenue streams, regulated assets with limited exposure to demand risk and standalone project financings.

The team's wider infrastructure investment experience includes PPP, regulated infrastructure, student accommodation, renewable energy, conventional power generation and transmission, airports, toll roads and other Core and Core+ infrastructure assets.

To-date, Dalmore has made investments in over 90 PPP projects and the Thames Tideway Tunnel as well as arranging long-term pension fund investment into the Clyde onshore wind farm project. In September 2015, Dalmore acquired a 50% stake in the West of Duddon Sands OFTO.

Dalmore's active management approach is based on alignment with the aims and objectives of the public sector, namely delivery of new assets to cost and programme and best use of the facilities in operation. To this end Dalmore aims to build and maintain strong working relationships with public sector clients and regulators.

Dalmore is party to a number of initiatives which enhance its' approach to corporate and social responsibility and has been a signatory to the UN-backed Principle for Responsible Investment ("UNPRI") since 2013.

3. Dalmore responses

Dalmore has provided below some responses to the questions posed in the August 2016 Ofgem consultation paper. Dalmore has not sought to answer all the questions, with focus being applied to those areas that are most relevant to the requirements of Dalmore's investment approach and investor base.

Chapter 1

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

We understand that the tender model and market offering mechanics are still being progressed. However, we are of the opinion that the proposals outlined will bring increased innovation and competition to the sector, ultimately allowing for savings to be passed on to the end user whilst protecting the consumer from undue cost and risk.

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?

We believe that the planned CATO tender process, proposed incentives and obligations will lead to the establishment of a low-risk, low volatility, long term asset class in the UK transmission space. CATOs will represent an attractive investment for a significant number of investors and competition amongst these investors should generate value for money for Ofgem through achieving an appropriately low cost of capital for this type of investment.

Ensuring that the tender process structure allows for sufficient competition given the limited depth of market of the supply chain will be critical to the sucesss of the CATO programme.

Chapter 2

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

We agree with Ofgem's thinking around the implementation of a 3-stage process which will clearly define and set-out bid submission requirements in a defined structure and better enable a bidder to develop and evolve their submission through a series of stages, over a prolonged period.

Further clarity and certainty from Ofgem around how you envisage 'robustness' of solutions being evaluated will be required as a lack of clarity may dissuade potential bidders from participating in what will be a costly process.

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?

The areas that we believe would benefit from further clarification/detail are:

1) Residual Value

We understand that bidders are to be asked to assume no residual value as a part of the tender bid submission. We also understand that, on an accounting basis, assets are to be fully depreciated by the end of the revenue licence term. However, we believe that the transmission asset life is likely to significantly exceed the 25 year revenue term of the CATO.

We envisage that, in many cases, the asset is most likely to remain an element of the energy transmission network beyond the revenue term which appears to be at odds with the nil residual value assumption. We would therefore welcome some further clarity around decommissioning and associated cost assumptions or other assumptions associated with the end of the revenue term that should be made for a prospective tender bid.

2) Revenue commencement

We note that the milestone for revenue commencement is to be set as construction completion. We understand the rationale for this being to ensure the CATO is appropriately incentivised to complete construction on time. However, we feel that other considerations should be taken into account in the market offering, with due consideration given to the type of investor likely to be able to provide the most efficient cost of capital.

Based on the inherent differences between some proposed CATO projects we note that there may be instances where projects require significant capital investment over a prolonged period of time. Even in the case of a 'late tender process', under which the majority of preliminary works would be undertaken by the SO and the construction period would be relatively short, a significant period of time with no yield despite significant capital committed may detract interest for certain long-term yield seeking capital.

A key element of attracting long-term institutional capital is stable and predictable returns. Dalmore was a successful bidder on the £4.2bn Thames Tideway Tunnel project, the largest construction project ever undertaken in the UK water sector. Despite being a complex project with three separate construction contracts and a seven year construction period Dalmore was able to raise over a third of the equity requirement from its predominantly UK and European pension fund investor base. A key attraction to these investors was the immediate yield during construction and the clearly defined risk sharing mechanisms in place between project stakeholders.

We believe that the CATO regime offering may be made more attractive to long-term institutional capital if a degree of yield was available throughout any particularly lengthy construction period, whilst simultaneously being in the best-interests of the consumer by increasing competition and lowering overall cost.

3) Project Pipeline / Deal Size

We believe that the potential for a pipeline of CATO investment will draw much attraction from Dalmore's investor base. Dalmore and its investors are especially attracted to investment areas providing a predictable flow of technically feasible and economically sound transactions. We understand that, at present, only projects from the Strategic Wider Works will be available for tender at RIIO-T1. However, it is unclear to us at this stage how many (if any) of the proposed transactions will proceed, and what potential projects this may include. We understand that to a large extent the identification of projects depends on the TOs progression and ultimately whether they reach final investment decision but an updated and clearly set out list of potential projects would be helpful.

In order for Dalmore to share investment opportunities with our current and prospective investors and to generate enthusiasm for investment programmes, it is important that the potential pipeline of assets coming to market is clearly understood. These investment opportunities should be of an appropriate financial scale to merit the required level of commitment of bid cost and resource to produce a suite of strong bids. Size may also be a determinant in the number of types of debt finance solutions available to bidders and hence in driving down the overall cost of the financing solution for the ultimate consumer.

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

We recognise that there may be some advantage to projects through the introduction of variant bids, particularly through the delivery of innovation. However we have some concerns around what impact this would have on bid evaluation and cost. If excessive emphasis is placed on variances it is likely that additional costs could be placed on bidders in order to derive (perhaps unnecessary) variances in what is already a costly process. We believe that testing variants around minor and clearly defined aspects of the project specification may be more favourable than substantially alternative solutions.

It would also require Ofgem to provide clarity on how variant bids would be evaluated or selected. Additionally if a bidder suggests variations but are ultimately not successful then there may be a question around who would own the intellectual rights to the idea.

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?

[No response]

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?

We believe the timeline proposed is sensible and appropriate for infrastructure projects of the magnitude proposed. Assuming formation of competing consortia comprising experienced infrastructure contractors and investors in the tender process we do not anticipate this being an issue.

However, further clarity as early as possible on the specific nature of the projects, in addition to longer term projects, will greatly assist with interaction with the supply chain.

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

As a minimum we would anticipate novation of all relevant contracts or agreements entered into in relation to the preliminary works, including the benefit of any warranties or contractors' liabilities being obtained.

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

We are comfortable with the concept of a share sale model for RIIO-T2 projects though note a concern around the transfer of employees who may be integral to the preliminary works undertaken.

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 consider that an issue could arise around the integration of HVDC technology into the CATO regime in relation to the objectives of Ofgem being to deliver competition, robustness and innovation and how this can be ensured through projects which require HVDC technology.

With a limited number of established suppliers in the market we believe that it may be difficult without active involvement from Ofgem to ensure that competition in bidding is maintained. For example prospective investors may be put-off bidding if they are not in a consortium with one of the established suppliers.

Whilst we acknowledge that there are alternative suppliers available these may be perceived to be less robust than the known market leaders and, as such, whilst they would - to some extent - deliver innovation through their introduction to the UK market this could be offset against a robustness score during evaluation.

We would request clear direction from Ofgem on how it believes that competition can be ensured and that any impact around the evaluation process is clearly set out in the tender process. For instance, it could be that certain components of the solution with a limited supply chain be provided through Ofgem during the ITT phase for bidding or finalised post selection of Preferred Bidder.

Chapter 3

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

With the exception of the delayed revenue payment which we have outlined in Chapter 2, Question 2 we believe that the proposed package of CATO incentives are clear, appear fair and reasonable and are in line with our expectations. We agree with Ofgem's philosophy that a degree of flexibility should be maintained to reflect the inherent differences between CATO projects.

In addition, we believe that limiting the maximum amount of annual CATO revenue at risk, as per the OFTO structure, will be key to ensuring an efficient cost of capital.

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

We are familiar with availability incentive mechanisms through our continued OFTO ownership and believe these mechanisms to be an appropriate and a positive step in encouraging proactive asset management.

Furthermore we agree with Ofgem's stance on the incentive target variance from project to project to reflect the inherent differences between CATO project types outlined in clause 3.28. The level of deduction and bonus payments should be set to incentivise the right behaviour of the CATO whilst limiting the downside risk in order to ensure an efficient cost of capital.

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 the principle of a NAP between a CATO and the SO (National Grid).

The aim should be to improve co-ordination between the CATO and SO, so as to reduce overall costs to consumers. This would probably include co-ordination regarding CATO asset outage planning, economic benefit sharing (for example associated with changes to the outage plan), benefit sharing if CATO actions help reduce wider system constraint costs and emergency CATO actions (such as outage curtailment) if faults/outages on parallel circuits not owned by the CATO would otherwise result in significant additional system constraint costs.

However, such a NAP would also have to recognise the performance measures and incentives applied to the CATO. These differ from those applying to the Scottish TOs.

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?

Dalmore currently has interests in multiple projects where asset condition is critical to the asset being perceived as 'available'. We believe it is likely monitoring and reporting systems will be in place to enable effective appraisal of the asset in line with good industry practice. At this stage, the degree of complexity of asset monitoring across all CATO projects is not fully clear due to the potentially different types of asset. It is therefore difficult to present a view on the best approach for appraising asset health for Ofgem as this could vary significantly by project. For example, the 'health' of a fully integrated CATO may require significant co-operation and assistance from another (interfacing) transmission operator and, in this instance, pre-determined responsibilities and obligations for each party would need to be clearly linked into the incentive mechanisms for them to be both fair and effective.

Dalmore is supportive of the approaches to ensuring appropriate asset management and potential financial incentives.

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

As an experienced investor in UK PPP projects, we are aware of the need for variations within a revenue term or concession agreement. Generally, we would welcome the opportunity for further investment if a corresponding return is also received. We believe more clarity is required on the obligation, particularly around the potential nature of the variation (and its impact on core asset operations), quantum, degree of third party funding assistance (if any), certainty of level of commitment of terms required at financial close and how the obligations associated with the variation assets might be integrated into the overall CATO project.

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

We believe any successful tender will already have demonstrated a deliverable, robust and sustainable capital structure. In order to ensure robustness of the CATO we believe several elements are key to a successful tender process including:

- Well-defined construction programme;
- Robust costing and appropriate contingencies/risk management processes;
- Pre-established risk sharing mechanisms;
- Strong security packages;
- Experienced, reliable and well renowned contractors; and
- Appropriate remedy mechanisms and periods to deal with project issues.

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?

This could be seen as a positive on the cost to consumers as long as the sizing of the security and obligations around the rating requirement are appropriate so as to achieve the right level of incentives for successful construction completion without the cost of providing the security/rating outweighing those incentives through more costly bids.

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

We are familiar with this policy through our participation in OFTO investment and are comfortable with this proposal.

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)?

[No response]

Chapter 4

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?

As noted above (Chapter 2, Question 2), our investor base is predominantly made up of UK pension funds who are aiming to match their inflation-linked liabilities against long-term, predictable and inflation linked cashflows. The CATO asset class represents an attractive opportunity for UK pension funds to invest in core UK infrastructure. However, a very long construction period which generates a prolonged period without yield on committed capital is generally not seen as attractive for pension fund investors.

We believe that in such instances it could be possible to use construction milestones with revenue incrementally stepping up to the profile agreed at tender as more elements of CATO construction are complete. We also believe that if appropriate risk sharing mechanisms are in place (e.g. similar to an NEC contract) then construction completion can be completed efficiently with multiple aligned parties.

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

As noted above, we are comfortable with accounting depreciation matching the revenue licence term but would like further clarification around the treatment of the CATO at expiry of the revenue term so as to better understand the proposed long-term CATO risks, rewards, role, responsibilities and obligations.

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

As noted above, we understand that bidders are to be asked not to assume any residual value as a part of their tender bid submission. We also understand that, on an accounting basis, assets are to be fully depreciated by the end of the revenue licence term.

However, we believe that asset life is likely to significantly exceed the 25 year revenue term of the CATO and would like to understand Ofgem's thinking on how the end of the revenue term might be managed vis-à-vis required assumptions for decommissioning, transition into a further revenue period etc.

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

As experienced investors in UK PFI and OFTO projects we are aware of mechanisms for sharing of any gain on refinancing. We are comfortable with the debt refinancing sharing arrangements proposed and see this as a way of further lowering the cost for the end user.

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?

We believe that a mechanism to capture some of the benefit of an equity sale requires further detail and clarification. We understand that, in the first instance, this mechanism may be designed to detract short term investors who are aiming to benefit from 'flipping' CATO investments won through the tender process a short time after purchase. Such a requirement may decrease the competition for CATO assets (and therefore the cost of capital achieved through the tender process) as only parties interested in or capable of a long term investment hold strategy are likely bid. Even amongst long term investors, there may be valid reasons for not keeping ownership of the CATO asset for the full revenue term, thus necessitating a disposal and potentially penalising otherwise long term investors. This may also dissuade some long terms investors from participating.

It is not clear how this mechanism would work in practice or how Ofgem would ensure the mechanism would be fair to all parties and we believe this could have a negative impact on the level of competition in the sector.

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?

In general the proposed risk allocation outlined in Appendix 7 of the consultation document is in line with our expectations and particularly in line with our experience of OFTO assets.

We note that reference is made to reopeners throughout the consultation which we consider to be fair though request some clarity from Ofgem around what 'cases' it is envisaged would qualify for reopeners with reference to the risk allocation outlined.

The allocation of tax as a CATO risk is something which we suggest is investigated further given there have been a number of significant tax legislative overhauls in recent years (e.g. BEPS). We believe it is questionable given this uncertainty that the CATO pricing tax risk fully would provide value to the consumers. In addition, further analysis should be undertaken on if this would allow an efficient cost of capital and investment grade rating throughout the CATO life to be achieved.

Finally we support the idea of the use of an independent party to provide assurance on preliminary works before or during a tender as we expect that this will facilitate a more transparent and efficient process and provide a degree of comfort around the preliminary works to be transferred. With regards to the mitigation or allocation of risk relating to the preliminary works we believe that the requirement of the TO to carry out remedial works along with the provision of indemnities to the CATO is fair.

4. Contact Details

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