

Response to Ofgem Consultation on:

Extending Competition in Electricity Transmission: Tender Models and Market Offering

CHAPTER: One

Question 1

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

Overall believe that the proposals defined within this consultation document provide a good platform for competition in the onshore transmission market

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 the proposed policy is well thought through and provides a good basis for competition. There are a couple of areas where we think the policy has the potential to reduce competition and we have highlighted these in our responses.

CHAPTER: Two

Question 1

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

Overall we believe that the proposed three stage process of enhanced pre-qualification, outline proposals and invitation to tender will provide a robust and transparent selection procedure.

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?

EPQ Stage

In respect of the proposed weightings which will apply to bidders responses at the EPQ stage, it would be helpful to understand the weighting criteria and its application to bidders' responses in respect of the pass / fail benchmark.

OP Stage

We consider the evaluation process proposed at the OP stage seems fair. Again it would be helpful to better understand the weighting criteria and its application, in order to provide further comment. We welcome the proposal to use the OP stage as a stringent selection barrier for progression to the final ITT stage and the intention to limit the number of ITT proponents. We do however feel that limiting the number of proponents at the ITT stage to three would enhance the level of interest in the competition during the costly final stages.

ITT Stage

We believe the proposed process for the ITT stage is well thought through and should allow for the robust, transparent and fair selection of a preferred bidder. Our experience is that the proposed equal weighting on the technical and financial aspects of bidders' proposals, will provide a fair and robust evaluation of submissions, which offer different and often innovative solutions. We believe this approach will drive best value for consumers.

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 concur with your conclusion that variant or alternative bids and solutions make fair tender evaluation more complex and that this can often result in additional work for both the bidders and the tender evaluation team.

In the early CATO process we would anticipate that the ability to develop, engineer and design a project to IEC standards, with input from all stakeholders, will drive innovation in the bidding process. We support a process for alternative bid submission in the case of late CATO model, particularly around defined engineering and design requirements. However we feel that the process of evaluating alternative bids would need to be transparent to all bidders in terms of process and value the alternative bid provides to consumers.

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?

We believe the fairest way to evaluate multi-faceted alternative bids, which often offer benefit and compromise for the procuring organisation, is on the basis of a whole life cost model comparison.

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 consider the timescales outlined in your proposals are adequate. However we foresee

that in the case of emerging technologies and limited supply chain, further time may be required during the ITT stage. We envisage that this potential could be evaluated on a project by project basis.

Question 6

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

We would expect novation of contracts or agreements made or reached during the preliminary works phase relating to consents, planning processes, access and rights of way, compensation payments or formulas, geotechnical and or ground investigation surveys, drainage surveys, third parties (i.e. DNO's, Network Rail, Highways Agency and the like) and any high level design and or engineering works.

We also feel that it would be beneficial to develop a standard set of terms and conditions for preliminary works to ensure that warranties, insurances, indemnities and the like are adequate and will meet bidders' expectations and requirements. Ofgem might consider consulting on this separately.

Question 7

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

Having considered both proposals we would prefer an asset transfer to a share sale, given the potential uncertainty about pre-existing liabilities, but believe both options could be made to work.

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?

Whilst in the round we concur with the comments made in 2.50., we believe that the real issue is around the limited supply chain for HVDC products and suppliers' ability and willingness to support multiple bids during the ITT stage.

The supply chain in the case of both HVDC converter station and HVDC cable is limited not only by supplier but also by capacity. We believe that it would be beneficial to engage with suppliers of HVDC technology early in CATO development process, in order to understand their views and the potential capacity issues of the limited number of HVDC equipment suppliers.

CHAPTER: Three

Question 1

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

We support Ofgem's proposals for CATO incentives and believe that they can deliver value solutions for consumers.

Question 2

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

In general, we believe the proposals strike the right balance between performance incentivisation and financeability. Availability based (not Demand based) incentives for 'Reliability' and 'Availability' are understood by operators, investors and lenders. As with any performance mechanism, the "devil will be in the detail" in terms of calibration of deductions and penalties to ensure incentives are appropriate to achieve the required standards, without being unduly onerous.

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?

It seems clear that the SO must be able to utilise the entire Transmission Network to both minimise transmission, reduce disruption in supply and reduce the risk of unplanned outages or loss of supply. The introduction of CATO assets should not impair the ability of the SO to manage the transmission network.

Our initial thoughts on this subject are that CATOs should participate in the development of a NAP in conjunction with existing TOs, other CATOs and the SO. At this point it seems logical that the SO would be the focal point for ensuring that a NAP for all transmission asset owners allow the SO to manage the system and minimise supply risk for consumers.

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 respect of your asset management proposals, we concur with the view that asset condition assessments should be undertaken at defined points during the licence term.

However we feel that it is likely that all CATO bidders will obtain warranties from construction and equipment / material suppliers, and as such believe that it would be beneficial to tie the initial asset condition assessment report to the end of the warranty period, thus avoiding duplication of effort. We would propose that 2 asset condition

assessment reports are prepared during the licence period at both the mid-term point and 6 months prior to the end of the licence term.

Question 5

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

Whilst, in principle, we support Ofgem's approach, we would want to understand the implications for the CATO of not being able to provide finance for new asset investment during the revenue term. Financing for CATOs (like OFTOs) is likely to be highly leveraged and constrained (i.e. with a high level of control by lenders). Committed financing for new asset investment throughout the revenue term would be very expensive. Uncommitted financing would, by its nature, not provide certainty that the financing would be available when required. We can see a number of scenarios where it may be difficult to raise financing (debt and equity) for significant new asset investment, for example, where:

- there are disruptions to the financial markets
- existing lenders to a project no longer wish to increase their exposure to the project or sector and use their controls to block new investment
- significant new investment alters the risk profile of the original CATO and existing lenders use their controls to block new investment
- financial investors have fully invested/committed their funds
- new lenders are reluctant to lend to the asset class because of widespread or high profile failures
- there is underperformance of a specific CATO project, whereby lenders are either unwilling to finance new investment until performance improves or are only willing to finance new investment if the project is put back on a more robust footing.

Ofgem could consider alternative protections where a CATO is unable to efficiently finance further investment, for example by introducing an obligation to provide access and standard interface arrangements for other parties to carry out the works.

Question 6

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

We consider that the mechanisms outlined in paragraph 3.54 of the consultation should provide Ofgem with a high degree of comfort on the risk of CATO financial distress. An investment grade credit rating would provide an external validation of financial robustness, but this might also restrict innovation as credit rating agencies take a strict and formulaic approach to rating construction risk. Achieving investment grade ratings for large, complex projects, with long construction periods may be challenging and/or expensive.

As discussed below, we believe that an alternative approach would be for Ofgem to require successful CATOs to meet certain pre-agreed “stress tests”.

We concur with Ofgem’s views on timing of equity injections and gearing levels i.e. they would not be efficient.

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?

We do not consider a requirement to provide construction security to the SO during construction to be efficient or necessary. It is likely that lenders will require contractors to issue 3rd party security as part of the debt financing security package, and this lender construction security could represent a material percentage of the construction contract. A requirement for additional construction security posted to the SO, particularly on large projects, could put a strain on contractors’ construction bonding lines and add a material cost to the project for little added protection.

An alternative approach would be for Ofgem to require successful CATOs to meet certain pre-agreed “stress tests”.

Question 8

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

We support Ofgem’s approach to CATO of last resort.

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 consider that the high level proposals for review of industry codes and standards for CATOs that are set out in Appendix 4 are appropriate. We believe that engagement with potential bidders on the review and proposed changes would be beneficial.

In respect of the best mechanism for us to facilitate bidder market understanding of industry codes and standards, we would propose a series of workshops for potential bidders to heighten awareness of the codes and standards and any proposed changes which are being made to accommodate the new CATO regime.

CHAPTER: Four

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 agree with the principle that revenue should start on completion for Late CATO build projects. For Early CATO build projects, there is an argument for early revenue to meet pre-commencement costs to avoid very long funding periods.

Ofgem has identified some areas where it may be appropriate to allow some revenue during construction for Late CATO build projects. We concur with these views.

- Phased completion: there are precedents from other sectors for allowing phased completion of projects, where the phases are sufficiently distinct to be able to test completion independently, and where the benefits from a phase begin on its completion i.e. are not reliant on completion of other phases.
- Long construction periods: a number of issues arise from long construction periods, for example, the ability of contractors to provide fixed price, lump sum construction prices over extended construction periods, and the willingness of lenders to allow long funding availability periods. There are precedents in other sectors for milestone revenue triggers during construction. These can be sequential and linked to specific works, or linked more generally to percentages of work completed.

Question 2

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

We agree with this proposal.

Question 3

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

We have experience of rollover arrangements and extension options at the end of the revenue term in other similar investment lead opportunities. We believe that it is difficult to fix these options at the beginning of a long licence period and as such believe that the agreement should make provision for the possibility and negotiation of a subsequent agreement.

Question 4

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

We support Ofgem's approach.

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?

Whilst we understand Ofgem's concerns, we believe that the mechanism could deter some investors from participating in the market. We also consider that the impact may be different on 'contracting investors' and 3rd party financial investors, some of whom match long term investments to long term pension liabilities. Contracting investors (e.g. transmission contractors) are not generally long term financial investors in projects – their shareholders expect them to 'recycle' equity investments from existing projects in to new projects. Contracting investors also take the majority of project risk through delivery of the principle subcontracts (especially construction risk). We believe that the ability to recycle equity is important for a properly-functioning contracting market and that mechanisms that reduce the ability or attractiveness of equity sales for contracting investors could be inefficient.

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?

The proposed high level risk allocation seems to provide a fair platform. Our main areas of concern are around the early engagement and interface with key stakeholders.

The interface with other Network and Infrastructure Operators / Owners will be necessary, particularly in respect of the initial discussions and agreements around outage planning and access windows. In our experience where these initial discussions are undertaken without proper consideration of the construction and other initial agreements, there can be a significant impact on the associated programme risk and delivery costs. In this respect we believe that the party engaging in these early discussions with Network and Infrastructure Operators / Owners should have some degree of programme management and delivery experience.

Early engagement with land owners and other stakeholders in respect of access and the sensitivities which surround projects of this nature, is vital and sets the tone and basis for long term relationships, which can impact significantly on programme and cost.

In both these areas (i.e. interface and engagement) we believe that there would be significant benefit in ensuring those responsible for the early engagement remain engaged in the process during the ITT development stage, and that bidders are provided with formal

access to the teams and individuals.

On the wider issue of mitigating and allocating the risks associated with preliminary works, as we have commented in our response to question six in chapter 2, the development of a standard set of terms and conditions for preliminary works to ensure that warranties, insurances, indemnities and the like are adequate and meet bidders' expectations and requirements would mitigate many of the potential risks associated with the transfer of the preliminary works to the CATO.

Carillion Transmission & Distribution Services.

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