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Dear Sirs

Extending competition in electricity transmission: Tender Models & Market Offering

Thank you for the opportunity to respond to the above consultation.

National Grid Business Development (NGBD) is a ring-fenced division of National Grid plc, responsible for developing new opportunities in line with our core business capabilities. We are responding to this consultation as a developer, investor and long term operator of future transmission solutions.

For clarity, as a business which is managed separately from National Grid Electricity Transmission (NGET), we are not in a position to comment on the impact of this consultation on NGET and our responses should not be read as such.

NGBD, as a developer experienced in interfacing with complex European transmission networks, is interested in tendering for any suitable projects as competition is introduced into the UK onshore arena. We have significant experience of interconnector development, which is an increasingly competitive area of the market, and have a robust approach to handling risk and managing projects in a way that ensures they are delivered safely and in-line with expectations. We are keen to apply our capabilities to the market to help facilitate the development of the most efficient and effective solutions. We support competitive tendering where it can bring consumer benefits.

Please find attached our detailed response to your questions.

We are happy to discuss our views contained within this letter, should that be helpful. For further details, please contact Mark Tunney (mark.j.tunney@nationalgrid.com).

Yours sincerely



Ian Graves
Director, National Grid Business Development

Detailed Response

In general, we support the overarching proposals and objectives. We welcome the fact that Ofgem have made deliverability a key part of the evaluation criteria. We would however, strongly suggest even more emphasis on project deliverability, long term customer value and availability of assets than purely cost saving through competition. CATOs must be set up to have the financial, technical and operating strength to deliver customer needs. Given CATO's potential importance to security of supply, the financial benefits of accepting a low-cost bid are likely to be far outweighed by the risk of late or inadequate delivery. We expect CATO companies to be highly geared and, if significant construction overspends are experienced, at more risk of insolvency than existing TOs. The suggested security posting will provide compensation to consumers in the event of financial distress but will not prevent CATO insolvency. A limit on gearing will make CATOs more resilient to construction cost overruns, and reduce insolvency risk.

While we understand Ofgem's motivation for favouring the Late CATO model, we would also highlight that the Late CATO model will introduce some risk (and therefore cost to the consumer) regarding the interface between the TO, carrying out preliminary works, and the CATO, who must rely on that work. It is unlikely that preliminary works warranties held by the TO will transfer to the CATO, or that the TO/SO will provide indemnities for preliminary works. This puts all of the risk regarding preliminary work onto the CATO due diligence and is likely to result in additional risk premiums within bids. We note that there is the option for bidders to point out specific areas where TRS could drop significantly if further preliminary work could be conducted by the TO. In the event that it is not possible for the TO to conduct this work, it may be advantageous for consumers to accept the risk, rather than face large risk-provisions within the tenders.

On a related subject, we would suggest that Ofgem look again at the potential to apply (as far as possible) the Early model to RIIO-T1 CATO tenders, or at least starts early in developing a process to accommodate this model for RIIO-T2. In our view this model mitigates the above risk and provides more opportunity for the CATO to apply innovative design. We understand that Ofgem are concerned about the risk that Early projects evolve, thereby undermining the CATO selection process. However, if the selection criteria include evidence that the bidders can adapt effectively to the expected changes, we believe that this risk can be mitigated.

CHAPTER: One – Introduction

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

We support the proposals which seem well aligned to the objectives; our key exceptions are noted above. We are also not convinced that the four listed objectives should be given equal weighting, especially as they may conflict with each other.

For almost all of the potential listed projects, we view the priority as 'deliver transmission infrastructure necessary to address system needs'. Lower cost is important and this might be delivered through competition, however if CATO projects are not delivered on time and to specification, they could have a larger socio-economic impact by constraining new sources of generation or leaving bottlenecks within the transmission network. This is different from the

OFTO environment where the assets are built by the generator before sale and any delay generally only affects the generator concerned. Delay or poor performance will have implications for the proposals themselves, e.g. for most projects we would suggest that the evaluation criteria should be weighted being mindful of the wider socio-economic drivers and long term value to customers and prioritise value and deliverability above cost.

The fourth objective is to 'create a strong competitive field by attracting new entrants and new approaches to the design, construction and operation of transmission infrastructure'. We would suggest that the introduction of new entrants is not an objective in its own right, but rather would be a possible outcome of introducing competition. In support of this, we think it is right that Ofgem have included no proposed evaluation criteria which favour new entrants.

We would welcome further clarification from Ofgem on the second part of this objective i.e. to attract 'new approaches to design, construction and operation' – as this seems to conflict with the decision to pursue the Late CATO Model. We recommend Ofgem adopt the Early CATO Model wherever possible to support this objective.

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?

Overall, NGBD are supportive of the proposals and we support strong performance obligations (e.g. 'payment on completion'). We acknowledge that the incentives package is comprehensive and well-focussed and we comment further on the proposed incentives in our response to Chapter 3 below.

We remain concerned that the proposal for the SO to carry out preliminary works where the late CATO build is used for projects in RIIO-T2, seems counter-intuitive to the 'efficiency' objective as the SO must build up the relevant expertise which already exists in the TO.

At present, it still remains the responsibility of the TO to identify potential options, and for the SO to evaluate and determine which should be subject to tender. In order for the TO to identify options, some initial preliminary engineering works will be required.

Inevitably, the separate SO and TO teams will have to work together through the preliminary works process; which could lead to a duplication of resource and hand-off costs but also increased risk for CATO bidders.

CHAPTER: Two - Late CATO build tender model

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

We are in favour of the proposed tender evaluation process which ensures only the strongest bidders are selected at each of the three stages. Whilst cost savings will be important, the

deliverability and energy network security are of greater consequence, we therefore feel evaluation criteria should be weighted towards deliverability for most bids.

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 consultation document includes a table of items to be evaluated which includes 'a detailed design for the assets'. Ofgem have stated they consider that detailed design would be required during the ITT stage and minimal design before ITT and pre-construction. This places a significant resources and programme draw during an ITT and without guarantee of remuneration. Typically, designs prepared during the ITT phase need only be sufficient to prepare a robust bid. We would like to further understand Ofgem's requirements in this particular area.

Regarding equipment standards, the consultation states that 'existing equipment standards will be sufficient....' We would ask for further clarification as to Ofgem's view of what these equipment standards are.

In order to further understand the tender process and evaluation criteria, it would also be helpful to know if Ofgem are governed or guided by any procurement legislation or regulation (e.g. the Public Contracts Regulations).

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 acknowledge the possibilities put forward for technical variants, and welcome this opportunity. In Ofgem's preferred late model, the CATOs will have already progressed significantly, through connection applications, stakeholder engagements, consenting under NSIP and development consenting process. This will restrict opportunities for technical or stakeholder variations, without undertaking significant revision and the consequential impact on programme costs.

We believe Ofgem should consider the value of having variant bids for commercial terms e.g. if CATOs feel they could take additional risks, removing re-openers proposed, for relatively small increases in bid revenue, or the ability to perform additional services thereby earning additional income which could be shared with 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?

Where possible, bidders should provide evidence to support the quantitative benefits of variant bids which would then form the basis of evaluation. For qualitative benefits (e.g. visual amenity) credit should only be given where these benefit the generality of consumers and can be evaluated in a transparent manner e.g. increase in the likelihood of delivery or reduction in timescales.

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 proposed timings provide adequate time for interaction.

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

NGBD would expect the following preliminary works to be novated upon appointment –

- Licencing and land rights, as required under the DCO process, including those access rights required in perpetuity.
- Surveying and design contracts as required; in order to develop sufficient detail and manage transfer risks.
- Any equipment and/or supplier contracts that Ofgem has deemed necessary to award, prior to the construction contract.

We would expect to also require access rights to the other TOs/DNOs for enabling works and connections and commitment from the SO in information transfer and sharing.

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

We would be supportive of either the share sale or asset sale options subject to further cost / benefit analysis. The share sale model appears to simplify the overall process however further work is required to ensure that legal and tax costs are minimised.

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?

NGBD suggest that Ofgem focus their efforts on providing visibility to the supply chain & allowing the supply chain to gain confidence that projects will be delivered. Locking in the supply chain too early (e.g. via advanced procurement ahead of license award) will lead to significantly lower competition and will limit design options. Counterintuitively, this may lead to upward pressure on pricing.

CHAPTER: Three - CATO obligations and incentives

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

The package appears complete, one possible exception is the inclusion of a target for transmission losses as clearly this will be a high priority for connecting parties and the SO. In practice, we feel that this should be a requirement of the tender specification.

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

We understand that Ofgem intend to allow for exceptional events i.e. those which could affect availability, but could be exempted from impacting availability incentive. Such exceptional events should be defined in advance to ensure a level playing field for tender returns and to avoid undefined risk for the consumer.

We do not consider a 'general target' for availability to be appropriate. As mentioned in the consultation document, assets will vary in maintenance requirements, usage and configuration; therefore a project-specific target will be required.

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 broadly agree that changes to the NAP and STC will be required to accommodate CATOs and that the CATO should contribute to future revisions of the NAP and STC.

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?

We are not entirely clear on the need for this incentive given the fact that CATOs will continue to own and operate the assets after the 25-year licence period, and therefore, should still be incentivised to maintain high availability of the asset(s). We understand the motivation is partly that condition assessments will ensure that assets are maintained in line with good practice and so any investment post 25-years should be reasonable. However, the commercial terms surrounding investment post 25-years will not be clear and so CATOs will be inclined to minimise the requirement for such investment. Also new technologies and smart asset management systems may help provide better information on asset availability, reliability and health and the metrics may change on the future.

It should be borne in mind that any security posted against asset condition will come at a cost which will be factored into CATO bids.

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

It seems reasonable that for any new investment, regardless of value, the CATO should be offered first refusal to build, own and operate the assets. This will minimise the technical and commercial complexity of new CATOs or existing TOs having additional interfaces with the

CATO. In terms of how much investment should be mandated, the £100m limit appears reasonable, below this level the existing CATO would then be compelled to construct and own, while above this level, Ofgem could have the option to tender as a new CATO.

We would welcome further detail on the commercial terms surrounding the new investment e.g. if the new investment takes place mid-way through the 25-year licence, would revenue recovery take place over a further 25 years or the remaining licence term? A further example is the treatment of preliminary works spends, in the event that the new investment was not eventually required.

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

NGBD believe this should remain a primary area of concern for Ofgem. As is the case for OFTOs, tenders for CATOs are likely to be highly geared. This increases financial risk, especially during construction. Both debt and equity financiers of CATO bids will be highly diligent in ensuring that CATO bid vehicles are de-risked as far as possible, but construction overspends will be inevitable on a proportion of projects and the CATO cannot always be fully protected.

It is not clear to us that the package is sufficiently robust to ensure delivery through the inevitable uncertainties of development and construction. We would advocate stronger protections for consumers, potentially including strong performance bonds or a limit on the gearing for CATO vehicles (including at the dedicated holding company level) as the most robust mitigation against this risk.

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 believe that construction security provides compensation in the event of financial distress for the CATO, rather than an effective form of prevention. While credit ratings would be transparent and independent and can be monitored on an on-going basis, ratings do not always move downwards before problems occur. We discuss alternatives under question 6.

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

NGBD anticipate that running a second bid process following financial distress will be time consuming and will inevitably lead to significant additional delays to the project. In our view, it would be reasonable to expect that CATO of last resort is arranged in advance, with key terms pre-arranged as far as possible.

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)?

The appendix does appear to cover all relevant industry codes and standards but clearly this list will need to be continued to be kept under review and updated as appropriate by the regulating body.

It is a reasonable assumption to expect that all bidders hold the relevant knowledge and expertise to ensure that they fully understand the appropriate industry codes and standards. We consider that this should be a prerequisite before a bidder is allowed to respond to an ITT request.

CHAPTER: Four – 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?

NGBD agree that some element of revenue during construction will reduce financing costs, however this is unusual (e.g. in the context of PFI projects) and so should probably be limited to projects with construction periods greater than four years. Any revenue paid prior to commercial readiness should be based on agreed construction milestones, ideally later in the construction period to reduce risk to consumers.

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

We support this proposal which will reduce regulatory risk for bidders and so should result in more efficient bids.

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

We understand that Ofgem cannot provide details at this time on the regulatory and commercial terms which will exist after the revenue term. However, Ofgem will need to form a view on the extent to which the bid revenue is being impacted by assumptions regarding post 25 yrs. Bidders will inevitably form a range of assumptions around revenue, costs and financing after the revenue term and this will in turn impact the robustness of the bid. Bidders should provide their assumptions regarding costs and income post 25 years.

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

The rationale for a high consumer benefit is that the potential for refinancing gain (post-construction) is high, given that construction risk will have passed. However financing costs are at historic lows and so may well rise during construction, this coupled with the requirement to share 70% of gains with consumers may well result in assets not being refinanced, even if modest gains are available. In our view it would be safer to set the sharing nearer to the 50:50 mark; in order to incentivise re-financings.

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?

It is our understanding of the proposal that gains from the sale of equity are shared with consumer via a set reduction in TRS in the event of a sale, in order to reflect the fact that Ofgem favour long-term ownership and any profit on sale should be shared with consumers. We believe that consideration should be given to a scenario where long-term ownership is preserved and yet an equity sale takes place. Examples include where a CATO is owned by several partners who are selling stakes to each other (in which case a revenue adjustment may not be appropriate) or if a CATO owner brings in a new equity partner. In our view the TRS reduction should be pro-rated for the percentage of equity being sold. E.g. if the CATO is a 50:50 partnership and only one owner sells its stake, the remaining partner should not be made to experience a drop in TRS.

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?

It is unlikely that preliminary works warranties will transfer to the CATO, or that the TO/SO will provide indemnities for preliminary works. This puts all of the risk regarding preliminary work onto the CATO due diligence and is likely to result in additional risk premiums within bids. We note that there is the option for bidders to point out specific areas where TRS could drop significantly if further preliminary work could be conducted by the TO. In the event that it is not possible for the TO to conduct this work, it may be advantageous for consumers to accept the risk, rather than face large risk-provisions within the tenders.
