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Date:
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Dear Gordon

Extending Competition in Electricity Transmission (ECIT): Tender Models and Market Offering

SP Distribution plc, SP Manweb plc and SP Transmission plc. (“the network companies”) are the “asset-owner companies” holding Scottish Power’s regulated assets and distribution and transmission licences. Scottish Power operates along divisional lines, and together, the activities of these companies fall within the Energy Networks division “SP Energy Networks” (SPEN). This response is from SP Transmission plc (SPT) the onshore Transmission Owner (TO) for the South of Scotland. As a TO we must ensure that we develop an economic, efficient and coordinated onshore transmission system and therefore welcome the opportunity to comment on this consultation on Tender Models and Market Offering

The current proposals provide useful detail on the proposed tender process that would be applicable for strategic wider works (SWW) projects that could be tendered under the current price control period (RIIO-T1). However, the 2015 Networks Options Appraisal (NOA) report highlights that the SWW projects are unlikely to be required before the end of the RIIO-T1 period in 2021. It is therefore possible these proposals will not be required; nevertheless they do present a useful building block towards an enduring regime, and highlight issues that need to be addressed.

Do the proposals meet Ofgem's objectives for onshore electricity competition?

Overall, we consider the proposals are not wholly aligned with Ofgem’s objectives for onshore competition. The proposed process is not necessarily going to improve on the existing process for delivering infrastructure to address system needs, may add delay and could reduce efficiency and co-ordination.

We welcome the approach to tender evaluation, but are concerned the proposals for transfer of assets may be difficult to implement in the RIIO-T1 period due to the limitations of the existing consenting regime in Scotland. The proposals for competitively appointed transmission owner (CATO) incentives are appropriate although the lack of a customer/stakeholder incentive should be rectified. Additionally, an Energy Not Supplied incentive could well be beneficial in some circumstances and should not be eliminated at this stage. The proposed CATO obligations and activities are suitable and appear to align with existing industry codes and frameworks. We agree the CATO role will align more closely with an incumbent TO than that of an OFTO

Our experience indicates that early engagement with the supply chain is difficult prior to certainty of a

contract being secured by a client. This undermines the assumption in the proposed process that supply chain development and co-ordination can be achieved at an early stage. The proposals therefore may not provide value for consumers but they do provide a basis of attracting new entrants to the operation of transmission infrastructure

What do the proposals not address?

There are two areas we would like to have seen addressed that are not.

Firstly, we consider the proposed tender process should include a project specific impact assessment as recommended in the select committee report¹. The consultation confirms Ofgem are assessing the suitability for competition of the North West Coast Connections project. However, no information is provided as to the methodology used and on what basis a decision will be made. It would be reassuring for consumers to understand the potential benefits of competing a specific project compared to a counter-factual. This type of assessment should be established as a formal part of the proposed tender process.

Secondly it is not clear yet how an incumbent TO would be able to operate a CATO licence should it be the successful bidder following a tender process. The requirement to establish a bidding team is understood in respect of assets in a TO's own area to avoid conflicts of interest where it has secured the preliminary works. However, the design development, construction and operation of the new transmission infrastructure out of its area may require changes to its existing licence to be made. We look forward to Ofgem providing more information on this area.

We have responded to the specific questions posed in the above consultation in the attached Appendix 1. Please do not hesitate to contact me should you have any queries in relation to our response.

Yours sincerely



Alan Kelly
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Network Planning and Regulation

¹ House of Commons Energy and climate change Committee, Pre-legislative Scrutiny on the Government's draft legislation on Energy, May 2016

Appendix 1: Answers to Specific Questions

CHAPTER: One

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

Ofgem explain four objectives for introducing competition in transmission are described in 1.1. Our view is that the first three of these objectives are unlikely to be achieved.

The first of these objectives is to provide value for consumers. However the proposed process, shown diagrammatically in 2.6, does not appear to include an impact assessment as to whether a specific project will be suitable for tendering or not. This was committed to by Ofgem in a previous consultation² para 2.4 of that consultation states:

Before making a decision to tender any RIIO-T1 SWW projects we will consider, on a case-by-case basis, whether tendering would be in the overall interests of consumers.

Ofgem indicated in their May consultation this assessment could take up to 10 months but this does not appear to be included in in the proposed process described in this latest consultation. This may be an omission of detail but does suggests the actual process will be longer than suggested here. It would be better to include in the tender process a defined stage with an approach and methodology as to how a project specific impact assessment is carried out and on what basis a decision to tender is made. This would provide a more robust case that value for consumers will be achieved against a counter-factual position.

Ofgem's second objective for introducing competition in transmission is to deliver transmission infrastructure necessary to address system needs. There is nothing to demonstrate the proposed process will improve on the existing process for delivering infrastructure to address system needs and may add delay and is likely to reduce efficiency and co-ordination compared to the existing process.

This is because the proposed process is linear and relies on completing each stage to reduce risk, uncertainty and thereby attract new entrants. The existing process allows for more flexibility as a more iterative process is possible with risk being taken by incumbent TO's, mitigated by the responsibility to deliver the end to end process and own and operate the assets for 45 years.

² Extending competition in electricity transmission: criteria, pre-tender and conflict mitigation arrangements. Ofgem. 27th May 2016

Ofgem recognise this in para 2.8 but their conclusion that these projects could still be tendered without delay nor will be needed in the majority of CATO tenders is contentious.

Ofgem's third objective is to bring about timely, economic and efficient development of the GB transmission system. However, the proposed process requires consents to be granted before starting the ITT stage, compared to the existing SWW process where it is possible that some contracts could be placed in advance of consents being granted. Also in the SWW process the period after the final needs case submission and project assessment does also allow more opportunity for project development and supply chain engagement as there is certainty on who will be delivering the project; whereas the proposed process is still running the competitive tender process at this stage, which will extend the development timescales.

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 consider the implications of the overall policy are positive but that the process may not be able to deliver the benefits to consumers.

The intention to only commence revenue once assets are complete does provide a strong incentive on delivery but could add risks to the quality of the build. There may be scenarios where some revenue is released in advance of completion. We agree that the lowest cost bids do not necessarily provide the best value for consumers and welcome the policy to ensure bids are robust, deliverable and do not add undue risk to consumers.

We also welcome the objective to attract long term investors although would highlight the existing regime achieves this already. The approach to sharing any windfalls should a CATO secure cheaper debt than it bids in the tender is in line with the RIIO-T1 gain share approach and of potential benefit to consumers overall.

Overall the incentives are broad and reflect the RIIO-T1 incentives for onshore TO's but with consideration of the scale of a CATO. The omission of a customer/stakeholder satisfaction measure is disappointing and should be included going forward. Customers were placed at the heart of the RIIO regime and this should be reflected in the CATO incentives.

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?

The four stage approach does provide the potential for a robust tender assessment. The timescales seem reasonable and the elements within each stage appropriate to achieve the outcomes. For example, we would expect pre-qualification criteria to focus on assessing relevant certifications relating to quality systems, health and safety and Environmental and confirmation of supplier's ability to deliver the high level scope of works with other relevant criteria that may be specific to the project. Tender evaluation should incorporate technical evaluation and the commercial evaluation of fixed price bids. We would expect certain re-openers and potentially a "re-measurable" element, but within a prescribed contractual governance, review and approval process.

The proposed approach presents a much more segmented process compared to the existing SWW process which we consider will add delay and cost. We consider the stage that assesses the merits of a project for competition is an omission and it is important for transparency and accountability that this activity is highlighted.

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?

It would be helpful to have a more detailed breakdown of the broad approach described for each of the eight sections and what the minimum thresholds are.

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

Variant bids do provide opportunity for differentiation in certain areas should be provided and could benefit consumers. However, as consents will have been secured and will likely have been on detailed designs, the scope for improvement may be limited. Visual amenity is a potentially significant area for improving local consumers with benefits but should not be limited to new technology with more cost effective benefits of screening or amenity considered. Transmission losses are less significant for consumers but a minimum standard should set for new assets.

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?

It is very difficult to assess bids that are by definition out with the scope of the tender. The main criteria for assessment should still be applied to a variant bid and if a variant bid is competitive on that basis any additional benefit on broader criteria could be developed, on a case by case basis.

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?

Yes we consider these timescales are reasonable, however, we have significant concerns about the assumptions that have been made regarding the nature of supply chain engagement when determining the timescales.

The expectation that the detailed engineering design will take place during the tender is not efficient and will place a burden on the supply chain. The requirement for all bidders to undertake detailed design work and for their supply chain to support this results in duplication of effort whose costs will ultimately be borne by consumers. The requirement for a supply chain partner to undertake such works when the award of contracts to construct the assets is inherently uncertain will be reflected in prices.

The assumption that the supply chain will be almost at contract stage prior to award of a CATO licence is flawed for a number of reasons:

- The successful bidder will be bound to its supplier and installer partners. It is possible that there may be more efficient solutions contained within other bids that were ultimately unsuccessful for other reasons. These more efficient solutions would be unavailable to the successful bidder, representing a missed opportunity to reduce costs for consumers.
- Experience of projects similar to those envisaged for the late model suggests that suppliers and contractors are unwilling to commit to projects which have no certainty of proceeding to construction. In this case, where their partner may be unsuccessful in the tender.

There will inevitably be concerns over confidentiality where the supply chain is engaging with multiple bidders. This is exacerbated where the supply chain may themselves be bidders for a CATO licence.

We are pleased that our engagement to date has led to the inclusion of the consideration of equipment standards. However, the paragraph (2.34) does not make it clear that compliance with these standards must be required by the tender. Neither does it recognise that it is almost universally necessary to detail which of the provisions of the standard apply to a particular application. We maintain our view that detailed consideration of this point is necessary to create a level playing field for bids, to allow bids to be fairly and transparently assessed and to safeguard the interest of consumers.

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

We would expect land agreements to be novated but are concerned that the necessary changes to Scottish arrangements will not be in place for RIIO-T1 projects to facilitate this. Obliging the party responsible for undertaking the preliminary works to transfer

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all relevant contacts and agreements, the benefits of warranties or contractor liabilities and any further project information to the appointed CATO would be an onerous obligation for that party. It could also affect the way that party procures that preliminary work and add to the overall cost of it doing so. We suggest that any obligation to novate contracts (other than planning consents and land agreements) is limited.

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 not clear on the benefits a share sale would bring and consider it may be difficult for incumbent TO's under their licence to set up companies to achieve this. Obliging the incumbent TO to set up a project company to complete the preliminary works could again affect the way that party procures those preliminary works and add to the overall cost and administrative burden of doing so. We therefore consider that this model creates an additional burden on the party undertaking the preliminary works without a corresponding benefit to the appointed CATO.

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?

The limited number of potential suppliers and the bespoke nature of HVDC projects will render considerations we have outlined in our response to question 5 particularly acute in this case.

CHAPTER: Three

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

The proposed set of incentives are reasonable and reflect the role a CATO will have and appropriately reflect the incentives on the incumbent TO's under RIIO-T1. The lack of a customer/stakeholder satisfaction is the only obvious omission and this should be included going forward. Although CATO's may have limited numbers of stakeholders or customers, incumbent TO's also have relatively few but are subject to an incentive regime in this area. Stakeholder engagement is a fundamental element of the RIIO-T1 principles and should be reflected in some manner for CATO's.

It is not clear why Energy not supplied (ENS) is excluded, as an unplanned outage due to risk of or actual asset failure may have a major system and customer impact whether or not the asset has customers directly connected to their assets. We therefore do not agree that Energy Not supplied (ENS) is an inappropriate metric for CATO's in every situation and should be kept as an option for a CATO incentive going forward.

The incumbent onshore TO's are subject to an ENS incentive currently and are liable for the impact of customer interruptions even if the source fault is on an adjacent transmission network. To ensure a level playing field ENS needs to be considered for CATO's.

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

The approach proposed seems reasonable but the actual targets will need to be set on a case by case basis to meet overall system needs. The balance to ensure asset maintenance is not dis-incentivised by maximising availability needs to be clearly struck. For example, if a defect is identified on a CATO asset after the year ahead plan and availability target has been set, the proposed incentive could encourage a decision to delay any repair works until the following year. This could lead to a defect not being repaired in a timely manner and catastrophically fails. With the proposal that there will be no ENS incentive on a CATO this scenario may be more likely to arise. It is also not clear if the availability incentive should accommodate defects where a replacement programme impacts a CATO but the failure or defect was in another TO. As a minimum safety critical outages should be removed from the availability incentive.

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 is appropriate for CATO's to participate in the NAP process which is now an established process for the planning and operation of the network involving existing TO's and the SO.

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?

Asset management will be a core activity for a CATO and should be incentivised. The proposal under option 1 to assess asset condition at the end of the revenue term is weak. A CATO may dissolve as a legal entity at the end of the revenue term and could make revenue recovery difficult. Even if a recovery of revenue was achieved the damage has been done and the consumer may need to fund asset replacement earlier than would normally be expected. Option 2 presents a more robust approach with in period assessment of asset condition which allows more opportunity to rectify poor performance in this area.

We note that output measures, similar to the TOs' NOMS obligations are not considered as CATO assets will be new. We are concerned that this is a short term view and that incentives should recognise that, whatever the definition, assets can only be considered to be new for a short time. A robust mechanism should acknowledge the deterioration mechanisms of assets.

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

It is essential for CATO's to be able to accommodate new connections to their assets and assess the impact of changes to background generation in adjacent TO areas for the duration of the revenue period. However, the TRS model may be more sensitive to changes in investment requirements than the existing RAV model for incumbent TO's. A cap on expected investment is therefore reasonable.

Paragraph 3.35 assumes that all investments in a CATO's network will be identified and triggered by the SO. This will not be the case and any obligations and incentives should account for issues such as early life asset failures. We remain concerned that consideration is being given to investments on a CATO's network defaulting to an incumbent TO. We have commented previously that we do think that this is inappropriate and our position is that CATOs should be appropriately structured to manage all aspects of their networks.

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

We agree with the primary risks to CATO financial stability which have been identified. In high value, complex construction projects, contractor disputes may arise and the risk which such disputes pose to the CATO's financial stability should also be considered. Effective assessment at the tender stage should ensure only CATO's are appointed who should be able to withstand typical financial uncertainties. However, mitigation of risk in this area is appropriate and the measures proposed seem reasonable.

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?

Requiring CATO's to provide a construction security does provide a practical measure of reducing risk to consumers. The incumbent TO is obliged to maintain an investment grade credit rating and we therefore consider it appropriate for a CATO to be obliged to do so too.

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

It is reasonable to mirror the arrangements for CATO of last resort with those established in the OFTO regime. Appropriate funding to ensure the appointed CATO of last resort is not disadvantaged would be essential.

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 range of codes identified is appropriate although we would highlight existing TO's are not signatories to the CUSC. Inevitably, it will require the existing code change processes to identify the full scope of the changes required for each code. However, the areas listed do seem to be a comprehensive list and is a good starting point.

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 do agree there may be circumstances where it would be beneficial to allow some revenue before completion. This is less likely in the late tender model where the period from tender award to completion will be less than the early tender model. In the early model this could be tied to key project milestones including final design, consents, tender issue etc. In the late tender model, if there is a significant delay due to securing network outages then consideration allowing early revenues release should be made.

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

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The proposal to align the depreciation period with the 25 year CATO revenue term seems to be inconsistent with the decision to extend the depreciation period under RIIO-T1 to 45 years. It could also sets an expectation that the asset life is also twenty five years.

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

It is appropriate to expect the CATO to continue to own and operate the assets at the end of the revenue term. This should encourage long term investors and encourage good asset management behaviours during the initial revenue term. We note that a CATO's ownership at the end of the revenue term would be under "some form of price control". A suitable mechanism will need to be developed to ensure that a CATO is not incentivised to declare itself insolvent and abandon the asset at the end of the CATO revenue term.

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

We support the proposal for a debt refinancing gain share as described.

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 think this could have some merits and should be considered going forward.

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 are concerned by the degree of risk associated with the preliminary works which the partying carrying them out is intended to bear. In particular, we do not think it is appropriate or reasonable for that party to provide the CATO with a blanket indemnity in respect of the preliminary works or any rectification which is required in respect of them. Under the existing arrangements, the incumbent TO would not normally benefit from a contractual indemnity in respect of risks associated with the preliminary works so it is unreasonable for a TO to be expected to provide such an indemnity to a competitively appointed CATO.