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Dear Gordon

Extending Competition in Electricity Transmission: Tender Models & Market Offering

This response is on behalf of National Grid Electricity Transmission plc (NGET).

Executive Summary

We welcome work to explore the potential for extending competition in electricity transmission. We recognise that the focus of this consultation is on developing arrangements for projects that may be tendered during RIIO-T1, but that it also touches on aspects of the enduring arrangements for RIIO-T2. We have structured this Executive Summary accordingly. The need for more detailed transitional regime development and our welcoming of the process to further explore where the early tendering model might add value, form the two key themes in this response. In relation to the immediate need to establish a transitional regime we also highlight issues around: (1) the contestability of the North West Coast Connections (NWCC) project; (2) the management of asset transfers and the treatment of risk, revenue streams, incentives and obligations; and (3) the concept of variant bids. In the context of the enduring regime we focus on the role of the SO and TO in relation to consenting and the need to ensure that an early model can form a part of the enduring arrangements where appropriate.

Transitional Regime

The need for more detailed transitional regime proposals

We fully support establishing the detailed arrangements for how a RIIO-T1 project would be contested under the transitional regime. Certain areas of design would benefit from more clarity to enable readiness for a T1 tender.

- We are committed to working with Ofgem and the industry to develop the next level of detail in relation to all aspects of the competitive regime. It is important that this is properly thought through, understood and planned against in the appropriate timescales. Whilst a good start has been made, this is particularly pertinent given Ofgem are proposing to consult on the first potential transitional project later this year. There is a significant difference between high-level conceptual theory as to what a competitive regime might look like and an actual, practical, fully designed set of arrangements that can be properly understood by all parties. We recognise

that the current consultation does contain more detail in some areas than we have previously seen and we welcome this. Albeit, some of these developments give rise to new questions and uncertainties which themselves require further clarification, such as arrangements for the remuneration of new capex and the residual value of assets at the end of the 25 year term.

Contestability of the NWCC Project

More work is needed in order to determine whether contesting this project would be in the consumer interest and we are keen to help with this assessment

- We welcome the fact that Ofgem is planning to run an impact assessment on the potential to competitively tender the NWCC project, later this year. We have previously stated that such bespoke impact assessments are going to be of critical importance for transitional projects and we would also advocate their utilisation for projects in the enduring regime (RIIO-T2 onwards). We will respond in more detail on this project, when the specific consultation is published. As we are currently developing the project, we have a lot of knowledge which we think will be valuable to input into the impact assessment process and are keen to support this process in any way that we can. Our initial assessment suggests that the timescales for contesting this work are extremely challenging and the decision as to whether or not to compete the project will require careful consideration as it is vital that delays do not come about.

The management of asset transfers and treatment of risk, revenue streams, incentives and obligations

- *The question of ongoing liabilities for the preliminary works of contested projects remains a key issue.*
- *Further clarification is required on the arrangements for the remuneration of assets at the end of the 25 year revenue term and for any new investments.*
- *Further details are needed on CATO incentives and obligations. Of critical importance is that the CATO should be sufficiently incentivised to: deliver operational assets to required timescales; ensure those assets are available when the system requires; and to maintain those assets to a good condition.*
- We welcome the clear message outlined in this consultation that CATOs will be expected to accept project risk and undertake any necessary due diligence on the preliminary works. However, we continue to seek clarity that, should a TO ultimately transfer a project that it has developed to a CATO, it will not incur ongoing liabilities for the preliminary works undertaken. Whatever other considerations are determined on a case by case basis, we would welcome confirmation from Ofgem that delineating a clean break in terms of ongoing liabilities will be a central and consistent principle of the new regime.
- Leaving ownership with the CATO after 25 years, as proposed in the consultation, removes uncertainty about how assets would be transferred and to whom but raises additional questions. It is highly likely that the assets will form strategically significant parts of the network. For this reason it is essential that clear guidance is provided on the operational obligations the CATO will have after 25 years and clarity on how the CATO will be remunerated for continuing to maintain the assets and for making them available for use. These assets will have a residual value at

the end of the 25 year term. Clarity on the revenue model is required to enable prospective bidders to sensibly estimate that residual value. Similarly, details on how new investment will be remunerated also need to be developed and understood.

- We broadly agree with the proposals put forward for the incentives and obligations that the CATO should be subject to, however further details on how these would operate is still required. In designing the CATO's market offering, in terms of the revenue stream and operational incentives, it is vital that CATOs are sufficiently incentivised to: deliver the project to the required timescales and quality; have incentives that capture that specific piece of network's impact on system need (regarding availability); and to maintain those assets in good condition.

The tender process

The concept of variant bids under the late model

We welcome the intent underpinning the concept of introducing variant bids under the late model and support further exploration of this option.

- In developing the competitive regime, we are keen to see as much opportunity for innovation as possible. Given this, opportunities for innovation in the late model, within the constraints already set by the preliminary activities such as consenting, are worth further exploration. It is important that the right tendering model (whether early or late) is used in the right circumstances and anything that enhances the value of the late model is to be welcomed. Our view remains that the scope for innovation under the late model is incremental when compared to the scope for innovation across a much wider range of factors under the early model. However, given that the circumstances won't always necessarily be right to utilise an early model, this development represents helpful thinking on Ofgem's part.

Funding

Further details are required on how Ofgem will ensure that the incumbent TO that has undertaken preliminary works and tender support activities for T1 contested projects is fully funded for those. Moreover, funding for any early activities on RIIO-T2 projects that has not been covered in the RIIO-T1 settlement needs to be explicitly funded.

- It is critical that NGET, and indeed any relevant TO, is fully funded for all activities undertaken to facilitate and support the development of the onshore competitive regime, in particular in relation to the development of specific projects that may or may not ultimately be contested. (This is both in relation to RIIO-T1 projects and the early work on RIIO-T2 projects that have not been funded as part of the RIIO-T1 settlement.) Ofgem must ensure that those parties involved in undertaking preliminary and other development works are properly remunerated for doing so.
- Similarly, we would appreciate clarity and assurance from Ofgem in relation to recovering the costs associated with facilitating the tender process itself (such as producing the tender specification and populating the data room). This is an increasingly important issue as we move closer to the potential tendering of the first transitional regime project.

- Guidance on funding more generally is critical to ensure that we have clarity as to what development work should be undertaken in what circumstances. We need to have much more clarity on the details of how any funding mechanism and the associated package will work at the outset of the process and would welcome further detail in this crucial area.

Enduring Regime

The role of the SO in consenting and pre-engineering and development of an early model

Which party (SO, TO or third party) undertakes consenting and pre-engineering in the enduring regime remains a key design question. We welcome the ENA working group to explore and further develop an early model and to assess the circumstances in which it might add value and we will play an active part in this work. We also continue to advocate a third party consenting model for circumstances under which a late model is preferred in the enduring regime.

- We have stated in our previous responses that we do not believe it is in the consumer interests for the SO to undertake consenting and pre-engineering. We are therefore pleased that Ofgem acknowledge that the "... role of the SO in relation to competitive onshore tendering... must be considered in the context of the SO's wider role and incentive framework." We also welcome the fact that no decisions in relation to consenting and pre-engineering under the enduring regime have been taken and we look forward to engaging with Ofgem and the industry on further work on the SO's wider role. In the context of onshore competition, we welcome the ENA working group which is being set up to explore the pros and cons of the early model, its potential design and the circumstances in which it might be used. To us these feel like very helpful next steps in this area. Whilst our starting premise is that a workable early model has the potential to add significantly more value for consumers than the late model (in the right circumstances by promoting opportunities for innovation), there will also potentially be instances where the late model is the right answer. The key is to ensure that both models are properly developed and on the table, such that the right choices can be made as to which will add value for the consumer in the particular circumstances.

Contesting HVDC projects

Due to consenting and supply chain constraints, we continue to have considerable reservations regarding the suitability of HVDC projects for competitive tender under the late tender model.

- We disagree with Ofgem's suggestion that HVDC projects are suitable for tender under the late model. In our view, concerns regarding the potential need to procure a converter station before obtaining planning consents are valid given the variation in size across manufacturers. Local Planning Authorities have shown themselves unable to approve projects based only on general details. In those cases, consents have only been obtained when conditions have been applied which affect the buildings and equipment to be procured. Equally, potential issues relating to supply chain limitations around cable manufacture, leading to longer procurement

periods are also significant. It is not clear to us that there is sufficient market capacity to allow such schemes to be tendered under the late model in sensible timescales. In our view, the potential barriers identified are sufficient to make HVDC technology unsuitable for tendering under a late model and this is an issue that needs to be explored carefully with Ofgem and the industry.

Ben Graff
Head of ECIT

Appendix 1: Answers to consultation questions

CHAPTER: One

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

The proposals set out in this consultation are helpful, but we have highlighted above our continuing need for more detail on the specific policy questions. We have said all along that the benefits of competition will be based on getting a regime that works. Progress is clearly being made but much further work remains to be done. As we have already highlighted, the ENA working group on the early model will be an important next step. We look forward to supporting this and all other ENA and Ofgem working groups in this area, to ensure that we play our full part in helping to develop the competitive regime.

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?

The high level features of the proposed tender policy appear to form a reasonable offering to prospective bidders and we do not think they would dissuade serious participants from competing for a CATO licence. Albeit, it is difficult to make final judgements without seeing more detail in relation to these proposals. Other potential bidders will also express their views on the suggested arrangements and we are interested in seeing these and playing our part in helping to develop workable arrangements.

We think it is critical that strong mitigation measures are in place to protect the consumer against the risk of a CATO becoming insolvent or simply exiting for some other reason. This mitigation could be provided through the level of security posting, the agreed gearing limits or via some other mechanism. Clarity around this sooner rather than later would be helpful.

It is important for both security of supply and the efficient operation of the transmission system that CATOs are sufficiently required and incentivised to act in the best interests of consumers. With this in mind we would caution against efforts that seek to increase tender participation by moderating the proposed incentives or obligations for CATOs to the extent that so doing is likely to create increased risks to consumers and connecting generation due to the entrance of unsuitable participants.

We have previously highlighted a need for more clarity as to what happens at the end of the 25 year revenue period. Certain aspects of the regime have been helpfully clarified but additional areas of uncertainty have been created, most notably over the residual value of the assets after 25 years and the form of the obligation to fund new investment.

Leaving ownership with the CATO after 25 years removes uncertainty about how assets would be transferred and to whom but raises additional questions. It is highly likely that the asset will form strategically significant parts of the network. For this reason it is essential that clear guidance is provided on the operational obligations the CATO will have after 25 years and on how the CATO will be remunerated for continuing to maintain the assets and for making them available for use. These assets will have a residual value

at the end of the 25 year term. Clarity on the revenue model is required to enable prospective bidders to sensibly estimate that residual value.

Similarly, details on how new investment will be remunerated also needs to be developed and understood. Similarly, further details on incumbent liabilities, as highlighted in our Executive Summary, would be helpful.

CHAPTER: Two

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

In Ofgem's proposals for tender design, throughout this consultation there is an emphasis on projects being managed individually rather than 'hardcoding' rules and arrangements. We recognise that there is merit in this approach and that this could also be applied to the proposed weightings for the assessment criteria, in particular the 50:50 weighting of scores for deliverability and cost. This seems to us to be the right starting point and we would support it as the appropriate default option. However, we also recognise that it is possible that different projects will be subject to different priorities and drivers, and the option to flex weightings to reflect these could benefit consumers. Clearly the need for flexibility and the need for certainty as to what is actually being proposed are both important and should be carefully balanced, but a default starting premise of 50-50 feels right to us.

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?

We understand that each project is likely to call for, and assess, different specific requirements from tender participants within their bid submissions. It is critical that the anticipated content of bids, the evaluation criteria and the process for managing variant bids, is explicitly outlined well ahead of each individual tender process. In terms of the generic elements of the evaluation process that can be elaborated on at this stage, it would be useful to better understand the content of information expected in the OP stage and to see further detail under the sections in the ITT stage.

One aspect of the bid where further clarity is required is biddable indexation. Ofgem will need to define in advance how bids that have different indexation proposals will be compared (see paragraph 4.32). Similarly, if bids are allowed to incorporate different assumptions for the allocation of risks to CATOs (and consumers), Ofgem will need to define in advance how such differences would be taken into account in a quantified and objective way in order to compare different bids from different parties.

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

We have maintained the general view that the more flexibility that is afforded to bidders, the broader the scope for benefits to be delivered to consumers. As such, we welcome the philosophy that underpins the proposed incorporation of variant bids into the tender process for late CATO build projects. Whilst it is the case that the opportunities for cost savings from flexibility under the late tender model will be constrained by the design that makes up the terms of the planning consents, if improvements can be identified within

those parameters, whether based on technical design, equipment choices or commercial terms, then we support all efforts to consider opportunities for innovation.

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 would anticipate that this process will evolve as more projects are tendered. We expect that the assessment process would apply consistent weighting criteria for elements that contribute to the project bids in such a way that takes into account relevant probabilities and risks (e.g. around non-deliverability). This is likely to require careful consideration ahead of the tender stage to ensure bidder clarity going into the process. There may be value in carrying out an exercise to simulate a project tender to understand where variant bids may be introduced and how the evaluation process can then be designed to manage these consistently.

Clearly, for the tender evaluation process to be seen as fair and objective, it will be necessary for Ofgem to define in advance how weight or value would be attached to bids which reduce environmental impact and/ or loss of visual amenity (above the minimum requirement.) There may be merit in mandating non-variant bids whereby all bidding parties are required to submit non-variant bids alongside their variant bids. Under this process the winning bidder can be chosen on an objective basis by comparing the non-variant bids from all competing parties. Ofgem then have a further option of choosing which of the different (variant and non-variant) bids submitted by the winning bidder they wish to proceed with.

Variant bids will need to be assessed and scored against the same criteria as the non-variant bids. The key will be in ensuring that the questions that are used to score the evaluation criteria are broad enough to allow this to happen, and/or that the bidders are able to articulate how the variant bid meets the criteria.

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 tender process stages outline a viable approach to bidder assessment and we support the principle of progressive shortlisting to ensure that any undue costs for Ofgem and prospective bidders are minimised. The proposed 3-month window for the Enhanced Pre-qualification (EPQ) and 9-12 months for the ITT stages appear realistic in order to demonstrate bidder capability and to undertake development of the final bid. However, we do have some concerns regarding the level of detail and accuracy expected in the OP stage. Whilst we agree with the philosophy underpinning this intermediate stage, three months is not sufficient time to determine indicative costs with the potential supply chain (if these are expected). It would be helpful to better understand the detail expected in this stage, in particular with reference to the 'financial element', as well as the level of explanation required in the ITT stage to justify any subsequent deviations. This should include more detail as to the envisaged interactions between the parties at each stage of the process.

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

This will need to be explored in more detail.

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

We agree that there are a number of complications that would need to be carefully considered if Ofgem did advocate using the share sale model for transferring preliminary works. As we have set out previously, it is not in the interests of consumers for the SO or the TO to undertake preliminary activities in the enduring regime. Given this, if a third party late model is pursued by Ofgem then this question could form a key part of the design of that model depending on the preferences of those entities that come forward to do such activities.

Were one of National Grid's entities (SO or TO) to undertake the preliminary works for a future project, we would not support applying the share sale model approach to the transfer of those. Due to the complexities inherent in the share sale model, we would consider the asset sale model to be more appropriate.

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?

In our experience the HVDC supply chain is significantly constrained and the requisite lead time is such that early engagement with suppliers is fundamental to ensuring milestones and timescales are observed. We would not support a late CATO build model for HVDC that requires the SO or incumbent TO to conduct early supply chain engagement and/or start the procurement process ahead of a tender that then requires activities to be transferred to the CATO. Such a model would necessarily create risks and costs for project handovers, interfaces and allocation of responsibilities and would erode any potential consumer benefit.

More broadly we would like to re-iterate our concerns that we set out in response to the May consultation and in the covering letter of this response regarding the suitability of HVDC projects for competition under a late model. The complexities around HVDC projects, in terms of the supply chain and planning consent implications, severely limit the potential scope for net benefits from competition when compared to the difficulties in setting up the process. These are essentially turnkey contracts and it is difficult to see how further value could be derived from competition.

CHAPTER: Three

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

The proposed approach to CATO incentives is a helpful starting point, albeit we would need to see more detail to reach a definitive view. As outlined at the start of the chapter, different categories of transmission projects will have different implications on system operability. It is vital that incentives are sufficient (when assessed in conjunction with parties' obligations) to encourage the right response from a CATO. Albeit, we recognise that they must not be so strong that they distort how parties might bid for cost of capital.

In relation to availability, more detail is needed regarding TO - CATO interaction, given that electrical separability does not form one of the essential criteria of the regime. The greater the extent that TOs' and CATOs' incentives are aligned in terms of outcomes, the better the outcome for consumers.

From an SO perspective, CATO incentives should be tailored to reflect system need. For example, at times it can be preferable not to have network assets in service in order to help manage voltage, this value then needs to be captured in the design of the availability incentive.

It is important that a CATO is sufficiently incentivised to deliver a project to time and to quality. A concern remains for us that simply stating that a CATO will not receive a revenue stream until construction is complete, may not be sufficient incentive, set against the costs consumers might ultimately have to stand in relation to constraint costs should a project be delayed. (See further our answer to 4.1.)

When it comes to determining the detailed provisions for CATO incentives on a given project, we also want to emphasise the importance of the SO's input into this process in order to ensure that the requisite CATO behaviours are appropriately captured (without over or under- incentivising).

On licence obligations, likewise we agree that for CATO projects different conditions will be more or less appropriate depending on the nature of the assets and agree with taking a flexible approach to these (around a core CATO licence structure).

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

As stated above, we support the concept put forward of maintaining a CATO availability incentive that can be structured to reflect the type of project and its implications for system operability. Therefore we support the proposed option of being able to apply bolt-on weightings for different project types.

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 are keen to work with all parties to ensure that the appropriate arrangements are in place to facilitate participation in the NAP.

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?

It is vital that CATOs are suitably incentivised to maintain their assets in good condition in order to ensure that the greatest possible value can be derived from investment in these assets that is undertaken on behalf of consumers. There could be a number of different mechanisms that might achieve this end. The key is to ensure that whichever is used, the underlying commitment that results is strong enough to deliver the right outcomes. The interests of consumers will only be adequately protected if the proposed financial security which the CATO is required to provide is at least equal in value to the lower of (i) the remaining value to consumers that the assets should have had, or (ii) the cost at any time

of restoring the assets to the appropriate condition (so the remaining value of the assets to consumers is restored.) Given the significant mismatch between the notional asset life for many onshore transmission assets (45 years) and the proposed 25 year depreciation period for CATO assets, the required financial security is likely to be very significant, especially (but not only) towards the end of the 25 year revenue stream.

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

It would be helpful if Ofgem could clarify the circumstances where new investment is relevant. Expected investment over the 25 years should be included in the original bid (e.g. replacing assets that only last 10 years). In this sense investment and opex are both part of the original bid and are implicitly remunerated as totex (they are just part of the total remuneration). There needs to be a clear demarcation between the treatment of any investment that might be reasonably expected during the revenue stream period and investment that is genuinely new and unanticipated.

There may be issues with obliging the CATOs to fund new asset investment – but there would also be problems if they did not have such obligations. The total amount of such incremental investment could be significant when compared to the initial CATO project cost (and could even be many times the initial CATO cost.) An obligation to make new investment(s) would therefore constitute a significant risk to CATOs unless there is clarity over the regulatory framework and how the future revenue stream would be set, which would need to be on a basis of giving a reasonable return. It is vital that Ofgem move beyond the current statement (paragraph 3.38) that “we expect to provide further details nearer the time...”

In almost all other respects the proposed framework significantly de-risks or at least further clarifies the risk exposure of the CATO project. However, the benefit of this for consumers will be reduced unless the risks related to new investment are similarly reduced or clarified. This will require the framework and detailed mechanism for setting the revenue stream associated with new investment on CATO assets to be defined in advance. This should involve a pre-agreed methodology which calculates an additional revenue stream in respect of each additional new investment including how the capex, and O&M costs and the allowed return will be determined.

Provided that a clear mechanism is in place for Ofgem and the CATO to agree the efficient costs of any new investment needed and thus the associated additional revenue stream, it would make sense for the CATOs to be responsible for new asset investment required on or connecting into their assets, as this would minimise the number of interfaces etc.

In the light of the above, Option 2 at paragraph 3.36, i.e. “Establish a cost threshold relative to initial capex”, would appear to balance better the different considerations than Option 4.

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

It is important in protecting consumer interests that CATOs are financially robust, including during the construction period. The measures proposed at paragraph 3.54, 3.56 and 3.57 should therefore be applied, even though these will carry some cost. It is also preferable

for the requirements on CATOs in this respect to be defined in advance using objective measures (such as those at paragraph 3.55) rather than for them to require Ofgem to apply judgment as to what is sufficient.

Paragraph 3.57 suggests that it may prove difficult for a CATO to obtain an investment grade credit rating during construction. An alternative which may be acceptable (when combined with a requirement to post an appropriate level of security), both during construction and in the subsequent operational period, would be for the CATO to hold an appropriate guarantee from one or more party(s) which hold(s) an investment grade credit rating.

The arrangements that a CATO will use to ensure it satisfies the prescribed requirements and will be financially robust at all times should be set out in advance in the tender bids, assessed carefully as part of the tender evaluation process, and where the arrangements fall short of ensuring the CATO will be financially robust the bid should be rejected.

7. What do you think about our proposal that CATOs should provide a construction security and have a credit rating during construction? How might this affect costs to consumers?

The cost to consumers is likely to be much greater if a CATO is unable to provide security or an appropriate credit rating. Electricity transmission assets represent critical national infrastructure and we cannot take inappropriate risks in this area. It would seem to be particularly important to have security (either security per se and/or credit rating) in place during the construction phase (consistent with the discussion in paragraph 3.57). Any cost to consumers associated with this is a necessary cost associated with implementing the proposed competitive regime. The financial security arrangements which are required should be set at the level which is necessary to protect the interests of consumers. In the absence of such a requirement, there may be a small saving from the removal from bids of the implied or direct costs of providing security, but consumers would instead bear the risk and associated costs of the successful bidding party failing during the construction period.

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

We would welcome further clarity as to who might be the CATO of last resort, what obligations might be placed on it, how the entity would be remunerated, how they might be identified and what impact this might have on competition.

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 would envisage that as part of the tender qualification process, demonstrating sufficient understanding of the suite of Licences, Codes and other arrangements, should be a pre-requisite for a potential CATO looking to progress to the next stage of the process. Whilst Ofgem may have limited resources, it will be incumbent on them, to ensure that would-be bidders for onshore transmission assets have some understanding of what they are actually bidding for and what their ongoing obligations might be.

However, clearly in our capacity as the SO we will do what we can (as we do with all existing parties) to help clarify the framework.

Turning to the ongoing development of Code based governance, the arrangements for the administration of these are likely to also require attention. Ofgem has undertaken a high level review of the scope of the proposed changes to industry codes and standards required for the introduction of CATOs. We agree that this is a good initial review of the requirements but appreciate that until a full detailed assessment of the various codes and standards is undertaken it is not possible to confirm if the proposals are comprehensive. We note that Ofgem is proposing further engagement with industry on the scope of the changes and expect that this will develop Ofgem's initial view. Even if the proposed changes are limited to those identified, it will require resource to be allocated to the change process to achieve the desired outcome in the required timescales.

For each project, careful consideration will need to be made of the functional design, where any specifications are not currently captured in the Codes. One example of this is the duplicated protection philosophy for 400kV and 275kV circuits which currently rely on the respective technical specifications used by the TOs (such as for control and protection).

CHAPTER: Four

- 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?**

Given the likelihood that delays in construction of CATO assets will result in costs to consumers (e.g. constraint costs), it is vital that the penalties to which the CATO is exposed for late delivery are of sufficient magnitude to incentivise the behaviours and decisions that lead to the most efficient outcome overall for consumers. Whilst 'payment on completion' would give some incentive for timely asset delivery, its effectiveness as an incentive very much depends on the circumstances in which the CATO finds itself during construction. In some cases, payment on completion would not be a strong enough incentive on CATO developers to take appropriate actions (which may incur additional costs) to ensure timely delivery, and so additional incentives should be considered. It is critically important that any cost benefit analysis faced by a CATO developer accurately captures the value to consumers of undertaking activities to avoid delays in delivery. Requiring some form of security finance (e.g. a bid bond) from CATOs that is subject to timely completion might be one means of supporting incentives to deliver.

There may be some limited circumstances in which some form of revenue before completion may be justified and would help to ensure the tender process best delivers value for consumers, for example, on a major project, of many years duration, where there are clearly identified separate stages to a project and intermediate milestones that progress can be transparently assessed against. However, considerable care would need to be taken to ensure that the arrangements incentivise the desired behaviours, and did not, for example, reward completion of intermediate steps where this might not always be aligned to ensuring prompt completion of the project as a whole.

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

The proposal to align the depreciation period with the CATO revenue term will remove an element of risk from a project from the perspective of the CATO developers and providers of finance and so should help to support the competitive pricing of bids. However, doing so potentially exacerbates the risk that CATOs will not be incentivised to make long term asset decisions on a whole life basis that are consistent with the 45 year asset life typical for other TO owned transmission assets. Therefore, a reduction in the depreciation period will necessarily increase reliance on other proposals designed to incentivise asset maintenance such as the CATO performance bond for asset maintenance. To maximise the benefit from this proposed change, it will be necessary to provide greater clarity over the arrangements approaching, and at the end of, the depreciation period (see our response to question 3 below).

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

As stated in our answer to Chapter 1, question (2), the proposal to leave ownership of the assets with the CATO helpfully removes some questions but raises new ones, particularly with regard to the ongoing obligations on the CATO and the revenue model after the 25 years. Both of these issues are critically important to the residual value of the assets for the bidder.

Clarity over the arrangements approaching and at the end of the depreciation period is fundamental to ensuring that bids are predicated on the correct assumptions of the responsibilities and risks owned by the appointed CATO. Not only must CATOs have clarity over their obligations to decommission their assets; in most cases it will be more important for them to have advance clarity (ahead of the tender) over any continuing obligations for them to maintain operation of the (fully depreciated) assets beyond the initial 25 year term, together with an understanding of the objective basis on which they will be remunerated for this and the penalties they would face if the assets do not continue to be made available for the benefit of consumers. These questions need to be considered alongside those concerning: asset condition measures and asset management incentives; asset health-related investment obligations; subsequent revenues after the end of the initial 25 year revenue period; and security arrangements and financial resilience obligations (particularly approaching and after the end of the initial revenue period).

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

We take a similar approach to equity share sales and debt gain share mechanisms. It is not clear that such sharing factors would actually benefit consumers. Nevertheless, if Ofgem's preference is to implement such a mechanism, it will be necessary to define what is meant by refinancing and the terms of any sharing arrangement.

When considering the refinance gain share mechanism (in the context of the two options presented in paragraph 4.25) it is important that the share ratio leaves sufficient value with the CATO to ensure that cost-effective refinancing options are incentivised and actively pursued where they may be available.

To be effective the arrangements also need to cater for financing structures where debt is held in holding companies.

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?

As with a refinancing sharing mechanism, if Ofgem decide to introduce a mechanism to transfer value to consumers in the event of a CATO equity sale, this potential loss of value and flexibility will be taken into account by developers in putting together their bids, and so it is unclear whether consumers would, on average, benefit from such arrangements being introduced. Investors often have a clear exit strategy and, in our view, it is likely that bidders will add a further premium to their bid if they think that future equity sale benefits will be shared directly with consumers. It is also likely that such a prospect will discourage a number of bidders, as it will make the regime less attractive to them.

However, clearly if these objections were rejected and Ofgem continue to see merit in allowing this, presumably it would be sensible to share the gains that result from a partial sale of equity by the CATO with the consumer via a set % reduction in TRS. This should be proportional to the amount of equity that is sold. Ofgem should also consider what tests and commitments a would-be purchaser of equity in an existing CATO would have to pass (if any) in order to become an owner.

As with debt refinancing, clarification is needed as to whether the equity sale mechanism would apply specifically to sale of equity in the CATO project company or would also apply to the sale of equity in a holding company that sits above the CATO project company.

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?

Whilst the risk allocation matrix provided in Appendix 7 suggests that the majority of risks will sit largely with CATOs rather than consumers, it is important to note that this does not capture all the risks associated with taking a project forwards through the late CATO build model, many of which fall on consumers. In particular, some construction risks will be amplified through the creation of more interfaces and handovers resulting from introducing more parties to the project development process.

We fully support the requirement for bidders to be held accountable for conducting due diligence during the tender process to their own level of satisfaction. Similarly, the bidder should be expected to factor contingency arrangements into their bids for unanticipated risks that may arise. However at the detailed level in practice, with a number of parties involved in different stages of the project, we expect accountabilities to be considerably more complex and less transparent than the allocations implied in Appendix 7. Furthermore, given that each project is likely to have unique traits, the opportunity for unprecedented and unanticipated circumstances to arise, for which the associated risks have not been explicitly designated, significantly broadens the potential for legal challenges and/or unforeseen risks to consumers.

The Risk Allocation Matrix implies the party responsible for preliminary works will bear some of the risks in the tender process and construction stages. We would like to re-iterate the principle set out in the cover letter to this response that the preliminary works party should not be subject to ongoing liabilities after the project has transferred to the CATO. Bidders should undertake proper due diligence and price additional cost risk into

their bid. Meanwhile the party conducting the preliminary works should be incentivised to do so properly but should not carry any enduring risks or ongoing liabilities for such works after the CATO is appointed.