OFGEM Consultation:

Extending Competition in Electricity Transmission: Tender Models and Market Offering

A Response by the Pensions Infrastructure Platform (PiP)

September 2016

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Executive Summary

The issue of pension funds' investment in infrastructure cannot be looked at in isolation from the wider economy and, specifically, the role of defined benefit (DB) pension provision. Despite the gradual decline of DB pension provision in recent years, over a third of the UK's workforce is still accruing benefits in a DB scheme, with schemes themselves managing over £900bn of assets. It is therefore crucial that employers sponsoring DB schemes can meet their obligations to scheme members without facing undue impact on their ability to invest elsewhere in the economy.

PiP has been working with its core Founding Investor pension schemes, the Pension Protection Fund, Railpen, British Airways, Strathclyde And West Midlands local authorities, to deploy capital in well-structured infrastructure projects as they recognise the benefits that low risk, inflation linked assets can bring to their schemes. Pension schemes are increasingly keen to invest in new projects rather than continuously invest via the secondary market provided that the investment risk and reward profile is suitable for the nature of investment offered. Allowing pension schemes to invest in such correctly structured projects as we believe the CATOs could be, would bring mutual benefits in lower costs to consumers along with enhancing the ability of UK pension schemes to meet their future pension obligations

The current procurement model has developed over time with contractors working in conjunction with specialist asset managers and this has successfully delivered to date. In turn this has led to the development of the secondary infrastructure market where by once the asset has been completed initial equity stakes have been sold on in the majority of cases to financial investors with a different investment objectives (e.g. yield generation) and perspectives for risk and return balance.

Our purpose of responding to this part of the CATO consultation is to challenge whether this established model is necessarily the optimum cost route for Government or whether by providing an option for bidders in the CATO process to choose to have an element of revenue during construction as would be the case in a regulated environment it could bring an lower overall cost of project delivery.

There does appear to be an opportunity here to provide OFGEM with a route towards a lower cost of capital creating the environment to establish a long term ownership model that would bring natural long term owners of assets associated with long term stable indexed linked income in at the procurement stage which could provide potential savings to the consumer.

The proposed CATO regime has the foundations to be a highly attractive regime for UK pension investment given its robust and stable regulatory regime and as such PiP welcomes the ongoing consultation that is currently being undertaken.

We believe that the proposal to tender for new, separable and high value onshore electricity transmission assets is an extremely interesting development and one that, structured correctly, could be of significant interest to UK pension schemes as they look to find suitable alternative investment propositions in the UK.

From the documents released to date and following the first round of consultations we are encouraged that the foundations of a framework to create a suitable structure for pension schemes to invest (as either equity or debt) is potentially being put in place. However, we would like to use this opportunity to reiterate our concern that the current proposal that revenue streams will not commence until the operational start date is likely to render this potential new asset class of little interest to UK pension schemes for the foreseeable future. As DB pension schemes must pay their pensions on a monthly basis liquidity is an important factor to them and as such there is a strong preference for the vast majority of their investments to be cash generative on acquisition. This requirement is increasingly a concern as schemes move towards the pay-out phase of their lives and from the increased flexibility now available through the freedom and choice regulations.

Following the success of the recent Thames Tideway ("TTT") financing, where PiP was instrumental in raising some £370m of UK pension scheme investment, it would be a major disappointment if the lessons learnt within this structure could not be used to develop a new form of hybrid solution that aligns OFGEM's objectives of incentivising completion with the needs of pension schemes for investment liquidity during the construction phase to ensure that they are able to efficiently perform their primary function of meeting regular pension payments.

If a favourable solution for pension schemes to the construction period income issue is adopted by OFGEM, PiP are confident that commercial solutions can be found with system operators, the construction industry and banking sector that would ensure construction period risk is significantly mitigated and a highly competitive cost of capital is provided by the ultimate long term holders of these assets. Suitable penalty regimes structured around established liquidated damages regimes would provide sufficient incentives to ensure timely completion of asset construction.

Overview of PiP Response

Introduction

1. The Pensions Infrastructure Platform ("PiP") is the UK infrastructure investment business set up "by pension schemes for pension schemes". Its objective is to facilitate investment into UK infrastructure projects by UK pension schemes, by developing investment vehicles which meet their needs in terms of structure, returns and cost.

2. PIP has been given a mandate by its founding investors to invest solely in UK infrastructure projects on a direct basis and in the primary or secondary phases.

3. PiP was established in 2012 following the signing of a Memorandum of Understanding by the National Association of Pension Funds ("NAPF"), the Pension Protection Fund ("PPF") and HM Treasury. PIP is owned by the NAPF and its development has been supported to date by 10 of the UK's largest defined benefit pension schemes.

4. PiP received FCA authorisation in January 2016 and subsequently launched the £1bn Multi-Strategy Infrastructure Fund ("MSIF") in March reaching a first close of £125m in April. MSIF is structured to provide pension schemes with a 25 year, low risk, inflation linked cash flow. This will be achieved by investing across the infrastructure sector in cash generative energy, utilities, PPP's, housing, communications and transport assets.

   In addition to direct investment MSIF will be used to facilitate co-investment by its pension scheme members.

5. PiP's first externally managed investment fund was launched in 2014. It is managed by Dalmore Capital and invests in PPP equity. The second fund invests in small scale (sub 5MW) rooftop solar PV installations. This was launched in February 2015 and is managed by Aviva Investors.

6. PiP also worked with Dalmore on the successful consortium bid to construct and operate the new Thames Tideway Tunnel ("TTT"). PiP was instrumental in facilitating £370m of equity contribution to the project by UK pension schemes.

7. Since its establishment, PiP has helped secure over £1bn of committed investment into UK infrastructure projects from its Founding Investors and other UK pension schemes The Founding Investors, who collectively manage over £70bn of assets, are now working with PiP to continue developing opportunities that meet the investment needs of pension schemes as PiP simultaneously opens its platform to the entire UK pension industry.

8. PiP will provide comment on the key question that affects the ability of pension schemes to invest in such projects: that of the lack of revenue during construction. On behalf of the wider pensions industry PiP has carried out extensive analysis that quantifies the potential benefit to consumers of facilitating investors with a lower cost of capital to invest at project initiation. This benefit could be up to £35m of savings over the project life for each £100m of CATO

capex. This benefit has been shown to be greater than the alternative method of a 100% profit share of a post-construction equity sale.

Background

9. Pension schemes have a fundamental obligation to pay accrued pension benefits to members, usually on a monthly basis. It is therefore essential that pension schemes have a reliable stream of income from their investment portfolios to enable them to fund these payments. This need for income effectively imposes a limit to the proportion of every scheme's investment portfolio that can be comfortably invested into non-yielding assets, such as infrastructure projects which do not return any cash to investors during a construction period. In general, the longer the period of no income, the less attractive an asset is for pension scheme investors.

   The current Ofgem proposals for the CATO's under which revenue payments to the onshore transmission asset owners will only begin upon completion of construction, will, all other things being equal, make these assets distinctly less attractive to pension schemes.

10. When pension schemes assess investment into long term, illiquid assets, such as physical energy related projects, which typically will be bought and held for 20-50 years, a key consideration is the stability of the operating regime and therefore the robustness of the long term financial forecasts which need to be made. Political, regulatory, legal and subsidy environments are core parts of this stability assessment.

11. The perceived stability and predictability of the UK are real competitive advantages. Indeed, the reason why the UK has been so successful to date at attracting pension scheme investors into infrastructure projects is because it is viewed as having a very stable political, legal and regulatory environment. It is impossible to look forward to the potential for any future infrastructure investment projects without stating the essential precondition that the CATO regime should be established in a way that would mitigate any potential for any retrospective legislation that would subsequently change legal contracts that have been freely entered into. Any such legislation would undermine the stability argument and severely damage long term investor confidence.

12. Where a system of regulated or subsidy payments forms a significant part of the operational economics of a project, it is equally important that these are predictable for the long term. This applies through the full project life from the earliest stages of investment appraisal, while funding sources are being secured and after project contracts have been signed.

Response to specific key question

Chapter 4, Question 1: What do you think about our proposal to start CATO revenue on completion? Do you have any views on whether there would be benefit in allowing some revenue before completion for certain types of project, and if so, what should this be tied to?

Revenue Start Date

As discussed previously pension schemes have a fundamental obligation to pay accrued pension benefits to members, usually on a monthly basis. As a result of this it is crucial that the vast majority of a pension scheme's asset allocation is cash yielding, particularly with regard to illiquid assets as they cannot be easily be sold to generate any required liquidity. This liquidity requirement has been exacerbated in recent years by the combination of the closing of DB schemes, pension's freedoms and low interest rates.

Under the current proposed model of revenue on completion the majority of pension schemes would have limited investment appetite due to the lack of cash generation for the duration of the construction phase. The current proposals will therefore continue to encourage the current model in which pension schemes take secondary positions post-construction and in our opinion potentially crystallise a significant overall loss of value to the consumers.

A change to, or at least an opportunity to provide a bid based upon a "revenue during construction" model would open up the investment opportunity to far greater pool of cost effective capital. This would allow increased competition on the cost of capital that potentially provides significant savings to the project and ultimately to consumers.

Savings to Consumer

PiP has carried out a detailed analysis on behalf of UK pension schemes that indicates changing to a "revenue during construction" model would provide consumer savings over a 25 year concession life of up to £30-35m per £100m of capex. These consumer savings would be driven entirely by the lower cost of equity capital required by long term pension scheme investors compared to short term developers.

	Current Model	Revenue during Construction
Capex	£100m	£100m
Gearing	80%	80%
Construction	4 years	4 years
Operations	25 years	25 years
Financing cash flow	£215m	£180m
With 100% profit share	£198m	£180m

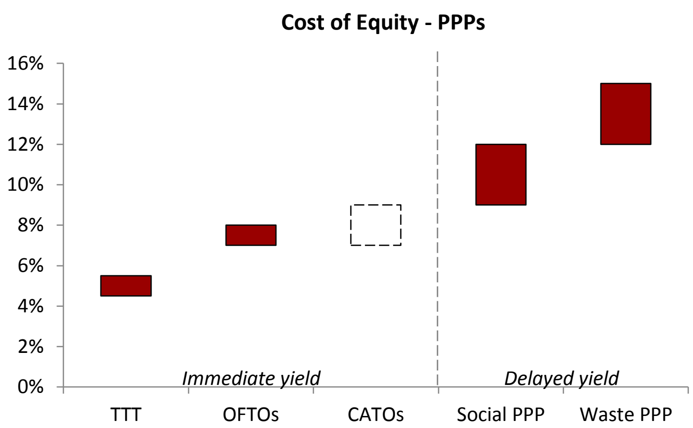
This analysis was performed on the basis of 80% gearing and a four year construction period. The cash flows required under each model to give the expected investor returns were then calculated. The savings from the "revenue during construction" model were £35m.

Increased Pool of Capital

UK pension schemes collectively manage over £900bn of capital. Historically this is been allocated primarily to listed debt, listed equities and property due to these assets ability to generate cash flow and having relatively liquid markets. Due to low interest rates in recent years, greater numbers of pension schemes are seeking to generate returns elsewhere. Infrastructure is seen as an attractive alternative due to its debt like characteristics of stable cash flows, low volatility and inflation linkage providing suitability for liability matching.

Traditionally UK pension schemes have allocated 1.4% (£12.6bn) of their schemes to infrastructure however since 2013 this has grown to over 2% (£18bn). This increase of £6bn reflects pension scheme's desire to generate positive cash flows as an alternative to negative yielding Gilts. An increase in the infrastructure allocation to 5% would therefore add an additional £24bn to the marketplace.

Two investments that have been beneficiaries of this increased pension scheme appetite are TTT and OFTOs. Both provide the investment structure that pension schemes require, as shown by their investors being funds managed on behalf of long term pension schemes; Allianz, INPP, Dalmore, DIF, 3i, and Equitix. This increased competition has resulted in projects achieving low costs of capital that are then passed on to consumers. Ofgem estimate that the OFTO regime has generated savings for consumers of £200-400m. Whilst OFTOs are already operational at the time of investment, it is indicative of the magnitude of savings that a correctly structured project can provide.



Source: PiP

Shown in the graph are the approximate costs of equity for other publicly tendered PPP's. Whilst there are differences between TTT (Thames Tideway Tunnel), OFTOs and CATOs it is clear that a correctly structured project with an immediate yield to investors can benefit from a significantly lower cost of capital

Proposed Revenue Structure

It is proposed that bidders be allowed to submit proposals that include an element of revenue during construction in much the same way as you have addressed the option to submit a bid selecting the amount of revenue that would be subject to indexation. Bidders should include in their proposal the required level of revenue, or percentage of capital they would seek it on, for each year during construction and the risk mitigants used to ensure that there is sufficient incentivisation or appropriate penalty regimes in place to complete the project in accordance with project timelines.

This will provide Ofgem the ability to make an informed decision based upon whether there is sufficient balance between the overall cost of capital introduced into projects against the overall risk of projects not being delivered on time and on budget.

It can then be left to bidding consortia to analysis the merits of introducing a long term source of capital at the outset to maximise the overall value to consumers of adopting this approach. The greater the allowed revenue during construction then the lower the required cash flows during the operational period of the CATO and therefore the lower total cost to the consumer. This is offset by an increased risk from reduced incentivisation to complete on time and on budget and as such we appreciate there would need to be some redress to ensure the capital providers were at risk in this event.

By providing at least an option for this to be included at the bidding stage then this will provide a chance for the UK pension funds to work creatively with the market to find a cost effective way for the natural long term holders of these assets to access the sector at project outset. This is something that PiP would highly recommend.

Risk Mitigation

PiP appreciates the desire to ensure construction is completed on time. It is accepted by UK pension funds that as equity providers this is a risk that they would need to manage, but PiP suggests that there are a number of alternative ways to address this rather than just commencing revenue on the start of commercial operations, for instance: penalty regimes; clawback of income; partial payment of any revenues (e.g. 50%.which if considered would then provide the basis for defined benefit pension schemes to become directly involved in the assets during construction.

Whilst accepting that the recent Thames Tideway Tunnel project may not be an exact template for all projects, it did find a creative way to solve the late delivery issue. In the case of a delay or cost overrun the TTT project will subsequently earn a reduced allowed return on the asset. This was combined with an incentivisition package covering all parties (investors and contractors) that encouraged the project to be completed ahead of schedule. These two combined to form a "carrot and stick" model that strongly incentivises all project parties to adhere to the required timetable.

A second possible model would be one of zero tolerance. This would simply remove all revenues for the duration of any delay. Investors would then have to ensure that they would be sufficiently covered by contractor damages in the event of such a delay, as is the case in a delayed or abandoned PPP currently.

PiP is confident that a suitable arrangement that works for CATOs can be delivered that satisfies the aims of all parties.

Consortium Format

The standard ownership model for PPP procurement is to have contractors providing an element of equity investment. This is to provide confidence to procuring authorities and debt funders that counterparties have "skin in the game" as well as giving the contractors a degree of control over the asset. It is expected this would be similar under a "revenue during construction" model.

Lower returns due to the long term ownership model are not expected to provide a disincentive as contractors have an alternative focus for their return. Obviously all parties have different strategic priorities for entering into transactions but for the likes of the Utilities and contractors (during both the construction and operation phases) we understand the primary interest will be around in securing the relevant construction or ongoing technical management and operational contracts for their core businesses as opposed to a balance sheet investment priority.

A benefit that contractors would see in the proposed model is that, given the high level of bid costs required for such a process, any method of increasing their chance of winning a tender would be seen to be very attractive.

Response Representation

This paper has been prepared by PiP taking into account the views of our Founding Investors and the Pension and Lifetime Savings Association.

Further Information

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