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Gordon Hutcheson
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Date 29th September 2016

Dear Gordon,

Re: Response to Consultation Document
"Extending Competition in Electricity Transmission: Tender Models and Market Offering"

We welcome this opportunity to participate in the consultation.

As discussed at our bilateral meeting, we have limited our response to a number of points primarily in relation to the proposed bid deliverables and the applicability of a project finance solution to the models proposed in the consultation document.

As a major infrastructure investment business with a broad experience in financing, constructing, owning and operating major infrastructure assets in the UK and abroad, we welcome this opportunity to deliver value to consumers through Ofgem's new approach to the provision of onshore transmission assets.

Overall, we agree that the proposals developed so far have been well structured and communicated. We think these are likely to offer attractive investable propositions to existing transmission entities and attract new bidders.

We appreciate that, at this stage, a number of areas require further development (and that this is recognised). However, there are a number of elements in the current proposals which we foresee will cause difficulties for potential participants, may dis-advantage new entrants or stifle the possibility to introduce innovation.

We trust that you find our contributions below useful in further developing your approach to this sector.

CHAPTER: Two

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?

ITT Stage:

Ref Section 2.23, Section 2 Design and Technical Specification, and Section 2.30 and 2.31: We would like to see greater clarity over tender specification and bid design deliverables expected through the ITT process as this is the major driver of bid costs. The consultation suggests "detailed design of the assets with the majority of the detailed engineering design work completed during ITT stage". We would like to see these further clarified so as to achieve the following objectives:

- Restrict design development to a level sufficient to define the scope and quality of the assets for the benefit of the procuring authority. Ideally design development would be limited to be within the design parameters of the FEED definition (tnei-Poyry Report of 27th May 2016).
- Focussed areas of detailed design development could be provided for critical components and/or small representative areas as reference for later overall detailed design development.
- Provide sufficient detail to allow the bidder to achieve price certainty.

As a principle, we would prefer the tender specification to bidders to be provided in as great a detail as possible to expedite the tender process and importantly to attract a wide range of bidders.

Ref Section 2.23, Section 3, Procurement Management: The consultation goes on to suggest "draft detailed contracts agreed with preferred suppliers or subcontractors, ready to be signed on conclusion of the tender process". Again this would add substantial cost and time to the bid process. Furthermore, normal practice would be for a level of design being undertaken whilst in competition as set out above for the purpose of supporting the bid of a fixed TRS. Finite agreed pricing with the supply chain would then follow completion of detailed design. We suggest the procurement process could be sufficiently evidenced by provision of agreed heads of terms with key supply chain partners including commercial arrangements with regard to any interface matters. The tender instructions could define particular commercial criteria that need to be included as a minimum.

Moderating bid costs is a benefit to consumers insofar as it will increase interest and thereby competition in the market place. Over the long term, it also mitigates the need for bidders to recover abortive bid costs from future tenders.

Question 5: Do you consider that our proposed tender process stages and timings provide sufficient time for interaction with the supply chain and bidders to undertake required design work in order to put forward robust, fixed price bids at the ITT stage?

The tender process and stages are sufficient provided the level of design detailing and commercial agreements are moderated as suggested in our response to Question 2 above. The key issue will be sufficiently advanced awareness of the procurement pipeline. Looking at the SWW projects, the key components vary greatly in terms of core disciplines ranging from overhead to underground and subsea to tunnelling. AC and HVDC options adding a further dynamic. This means the constitution of the CATO licensee and its supply chain may vary substantially from project to project. As Section 2.31 of the consultation correctly points out, supply chain engagement will be required well in advance of commencement of the tender process and accordingly a process of project prior information notice well in advance of the tender process would allow bidders to coalesce appropriate teams in readiness for the particular project's tender process, thereby facilitating bid deliverability and respective timings.

CHAPTER: Three

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

We believe Ofgem's current preferred proposal to oblige CATOs to fund future (uncapped) additional investment needs is likely to cause difficulties for CATO bidders and their funders for two major reasons:

- Funding requirement would be uncapped (and therefore potentially undeliverable); and
- There is presently no consideration of the appropriateness of the nature and scope of new investment, including alteration to the risk profile of the project or the technical expertise (construction and operation) within the CATO consortium.

This is likely to be unattractive/unacceptable to potential new entrants and/or their funders thereby reducing competition and the ability to introduce financing innovations/cost savings. Ofgem is however rightly concerned that the transmission system is not static and during the revenue period new asset investment may be required on or connecting to CATO assets and flexibility to accommodate future changes needs to be available.

Uncapped funding: The CATO regime is specifically targeted at separable SWW elements. These "stand alone" projects, particularly Point-to-Point and Radial projects, lend themselves to the financing efficiencies achievable under project financed structures. (Ofgem explicitly seeks to attract new entrants to the sector and encourage bidders to innovate and drive efficiencies across all aspects including financing.)

To obtain these advantages, bidders (and their funders) need to understand the size, scope and risk associated with the projects at the time of financial close. Funding requirements are sized and priced for the specific project thereby minimising financing costs.

Ofgem's current proposal to cap only each tranche of required new investment at £100m (with no limit to the number of new tranches) would in effect represent an obligation on bidders to potentially source an unquantifiable level of additional funds to build new assets.

Without clarity on how new assets costs will be developed, recovered and revenue earned, it is not possible for lenders to understand the potential impact on them (and their security) of these proposals. Further, as lenders are subject to their various lending restrictions, (such as group, product, country and industry lending caps), they are unable to offer unlimited lending capability, especially over the extended 25 year period contemplated or without understanding the risks associated with the proposed new asset construction or operation.

If the obligation to fund suitable new assets were to be capped, it would be possible for bidders to arrange this additional borrowing as part of its bid, thereby satisfying Ofgem's requirement to demonstrate access to the required funding. However, the commitment fees and other financing costs associated with this lending will form part of the bidders costs (whether or not the lending was ultimately required or not) thereby "baking in" potentially unnecessary funding costs and increasing the price. This is unlikely to offer best value to the consumer (but balances Ofgem's concerns that the transmission system is not static and during the revenue period new asset investment may be required on or connecting to CATO assets).

While not impossible to access capital market funding, the need for “variation bonds” to cover the prospect of further new asset expenditure will similarly come with a cost and may reduce the potential lending pool, and thus competitiveness of ultimate financing solutions.

Setting a realistic cap on total additional asset expenditure is required to quantify funding costs, minimise unnecessary funding costs and support the broadest potential lending group. The cap, along with individual sub-caps, should ideally be set at a level that does not significantly alter the risk profile of the project to the lenders.

We anticipate that the efficiencies offered by project finance are likely to form part of the innovation and structures that new entrants could bring to the sector. However, we foresee difficulty even for incumbents or others who propose to finance on balance sheet. It is unclear how an entity could suitably demonstrate the ability to commit to unlimited new build expenditure over a 25 year period without clarity on how the risks are mitigated, the costs recouped and revenues generated.

Technical expertise: Bidding consortia will form to best deliver the technical requirements of the initially proposed asset construction and subsequent operation. The current group of SWW projects vary in terms of core construction and operation disciplines, including overhead, underground, tunnelling and subsea. Those consortia will be evaluated by Ofgem with regard to the procurement and supply chain each has developed to deliver the requirements of the specific project as understood in the bidding phase. (Under project financed structures, the lenders will similarly ensure through their due diligence that they consider the bidder to constitute a robust technical group.)

As presently proposed, there is no limitation to the nature of the new investment works that may be required. There should be a check, at the time, to ensure that new assets works fall within the capability and expertise of the CATO. This may not be the case for unusual new assets. This should be a consideration of the SO when determining the party best suited to taking on the new works.

Ofgem recognises that not all CATOs will be the same in terms of scale, scope and purpose. Therefore, while establishing a baseline framework, you intend to allow a level of flexibility between projects. Particularly in the case of Point-to-Point and Radial (where there is expected to be limited interfaces with other network owners and users), capping new asset expenditure at a percentage of the initial project value (with a sense check on the type of new asset required) would optimise the benefit of new competition. The percentage could vary on a case by case basis, reflecting a reasonable pre-estimate of likely additional asset needs.

A mechanism could be developed to deal with the circumstances that breach the threshold but where it remains operationally efficient for those new assets to be incorporated into the CATO’s responsibility. In those circumstances the CATO could be requested but not obliged to fund. Where the CATO cannot provide the funding, but an alternative source is found, we envisage the new assets could be incorporated into the CATO’s operation obligations subject to reasonable protections excusing the CATO from negative impacts of construction or operation of the new assets, and assuming the overall risk remains largely unchanged.

Requiring bidders to commit to future undefined works (especially if unlimited in size or scope) may undermine the primary objective of attracting new entrants and encouraging greater competition and innovation in the provision of onshore transmission infrastructure optimising value to the consumer.

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

We envisage project finance structures, involving all significant construction obligations carried out by a substantive EPC contractor (under fixed price date certain contracts) and operations to be managed by experienced transmission operators. Selection of robust subcontractors (supported by appropriate security packages including performance and/or retention bonds, delay liquidated damages (subject to appropriate caps), appropriate defect liability periods) supported by strong parent company guarantees provides solid comfort that the obligations can be satisfied.

These arrangements are additionally reviewed, monitored and enforced by lenders (with methodology and price assumptions reviewed by independent technical advisers) further ensuring the robustness of proposals and the replaceability of any key subcontractors.

Provided only appropriate risks are transferred to the CATO, those arrangements (along with appropriate insurance, including delay in start-up insurance ("DSU"), provide significant safeguards and comfort that construction phase obligations are understood and will be performed as required.

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?

The imposition of an additional construction phase security bond (posted with the SO) and hold a minimum credit rating would inevitably increase costs to the consumer.

Construction security: We assume that under project financed structures, an additional security would not be required. Instead, the SO (and thereby the CATO of last resort) indirectly obtains the benefit of security established under robust project finance structures.

We consider the bulk of the concerns cited at section 3.53 are manageable or capable of being appropriately mitigated by successful bidders. For example through fixed price date certain construction and equipment supply contracts, replaceability of contractors, liquidated delay damages (when due to subcontractor delays) and/or DSU insurance (when due to an insurable event).

Appropriate risk sharing mechanisms could be developed under the Licence in relation to other, uninsurable events, including those causing material adverse impact.

Selection of robust subcontractors (supported by appropriate security packages including a level of performance and/or retention bonds, appropriate caps on liability supported by parent company guarantees) will also be scrutinised by lenders.

Lenders will take first right of security over the construction support package. Through appropriate direct agreements (between lenders, the SO/ Ofgem and subcontractors), the SO/Ofgem takes indirect benefit from the Lenders' obligation to work out the project (prior to a longstop date) if problems arise. If delays extend beyond a pre-agreed longstop date, at that stage, the additional protection/ CATO of last resort regime may be appropriate.

Credit rating: Obtaining a credit rating will inevitably add cost (and potentially time) to the initial funding process. While credit ratings have featured on some referable infrastructure projects in the UK and other similar jurisdictions (particularly bond financings), they are not commonly sought. The cost of security and impact of the necessary structuring required to bring a project to investment grade generally outweighs the gains in terms of financing costs and project security.

Similarly, it would be unusual for the project to be under an obligation to constantly refresh and maintain the rating throughout the project.

Maintenance of debt service cover ratios, reserve accounts and dividend lockup mechanism are designed to ensure a minimum cash buffer exists (without the need for independent credit rating analysis).

Where bidders do not adopt a project financed structure, for example through corporate loans or otherwise on balance sheet, we agree with you that there should be an equivalent level of scrutiny over their structures.

CHAPTER: Four

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

We agree with a gain sharing arrangement in respect of "windfalls". However, it should be recognised that the CATO's share in gains should be sufficient to incentivise optimal refinancing for the consumer, properly reflect the managerial effort involved and ensure that the regime does not inadvertently capture reduction in finance costs due to innovations that reduce inherent project risk.

It should be borne in mind that depending on the financial cycle, lenders (particularly banks) have on occasion significantly retracted from long term (more than 7 year) debt. There may be occasions where, on balance the likely value for money to consumers is enhanced by both a gain and pain share mechanism.

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?

Sharing of proceeds achieved on equity sale has not been seen in similar structures under which the private sectors performs essentially public sector services. The introduction of such a mechanism would represent a departure from understood norms.

When determining how or whether to pursue potential project opportunities, developers consider their cost of bidding in relation to likelihood of success (and compare this to other investment opportunities). While it is generally recognised that bid costs will be "lost" in respect of unsuccessful bids, this may be considered in the round as part of a portfolio of won/lost bids, well performing and poorly performing projects.

If bidders have reduced confidence that the overall performance of the portfolio makes up for the risk of lost bid costs we believe Ofgem may see the market needing to build higher initial bid costs (effectively smearing abortive bid costs across successful ones). This will increase initial cost to the consumer with no guarantee of a future (or commensurate) gain.

We believe it would be appropriate for Ofgem to impose "lock in periods" during which any equity sales would only be permitted with Ofgem approval. This limitation could appropriately apply during the initial construction phase (along with a period in which full operation is demonstrated).

We do not think an extended limit on equity sales would support a healthy and competitive CATO sector. Investors are currently incentivised to develop efficient deal structures, and establish robust well operating business that are attractive to future investors in the sector. Any change to understood norms should be carefully considered so as not to undermine this.

We trust that you find our contributions useful in further developing your approach to this sector. Should there be any matters Ofgem would wish to discuss further, we would welcome the opportunity.

Yours sincerely

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