

## Market Offering & Risk Allocation Workshop

### Context

As part of its extending competition in transmission (ECIT) project, Ofgem has established a steering group to assess policy options. This steering group is attended by TOs, potential CATOs, generators and the Scottish Government, along with the ENA.

ENA facilitated a stakeholder workshop hosted by Ofgem. The workshop took place on 6th September 2016. The ECIT steering group and Ofgem asked ENA to draft a short report to capture the views expressed by stakeholders at the workshop. **The note below captures those stakeholder views but does not represent a company position on these questions.**

Please note that this report should be read alongside the Ofgem's presentation slides from the workshop and

Chapters 3 and 4 of Ofgem's consultation document: 'Extending Competition in Electricity Transmission: Tender Models and Market Offering'<sup>1</sup>. This outlines their proposals regarding the Late CATO build tender model.

Annex 1 to the note includes a list of the stakeholders who attended the workshop on 6<sup>th</sup> September. Annex 2 to the note contains a list of key terms.

### Market Offering

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

There was generally good feedback from the group regarding the proposed CATO incentives.

A stakeholder asked what Ofgem was looking to achieve with the incentive package i.e. should it place a similar level of risk and reward as in other networks- RIIO, offshore and onshore. Ofgem thought this would be a good starting point for the basis of the regime but welcomed further comments.

#### Availability and reliability

Ofgem stated they are seeking stakeholder perspectives on whether availability targets should be set on individual circuits or across whole CATO systems. There was a preference among the group for targets to be set for individual circuits, although there was an acceptance that it might be difficult to set targets to this level of granularity.

Ofgem proposed reliability and availability should be wrapped into a single incentive. Incumbent TOs indicated this could potentially overcomplicate incentives and other stakeholders thought it was important to keep incentives as straightforward as possible to prevent them becoming a distraction.

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<sup>1</sup> [https://www.ofgem.gov.uk/system/files/docs/2016/08/extending\\_competition\\_in\\_electricity\\_transmission\\_-\\_tender\\_models\\_and\\_market\\_offering\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/08/extending_competition_in_electricity_transmission_-_tender_models_and_market_offering_0.pdf)

There was a request from the group for more detail to be provided on 'bolt-on' incentives before the commencement of the tender process to provide clarity to bidders.

#### Missing incentives

Members of the group questioned whether there were any incentives for reducing transmission losses. Ofgem responded stating they are not proposing to directly incentivise this but it may be considered under the reputational incentive around wider environmental performance. Ofgem stated they expect to evaluate transmission losses during the tender and will consider further how to do this.

One stakeholder questioned whether stakeholder engagement incentives should be included. Ofgem noted prospective CATOs will have relatively fewer stakeholders with whom they interact, though it may be appropriate for some project types.

There was a comment that many of the proposed incentives are 'negative' in that they revolve around compliance to a minimum standard as opposed to incentivising outperformance. It was noted that this absence of opportunity to outperform may foster negative and defensive attitudes amongst bidders. Ofgem indicated proposed incentives would be symmetrical where appropriate, e.g. rewards for performance and penalties for underperformance.

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

A member of the group reiterated that incentives should be kept as straight forward as possible so it may be prudent to avoid bolt-on's, however he recognised they could be beneficial in specific projects as different incentive structures may suit different project types.

A stakeholder questioned how asset availability would be incentivised under an annual availability incentive and suggested it may need to reflect seasonal variations but it was recognised that this could be complicated. There was a comment that the SO may have some useful input into this debate.

Another participant suggested having an availability incentive which is more customer focused, as is seen in OFTO model. Ofgem pointed out this may not be pragmatic as there are different types of CATO, some of whom may not be connected to generators and incentivising the availability of assets when required as per an agreed outage plan is potentially more significant for overall network operation.

#### **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?**

There were mixed opinions surrounding the proposal for the CATOs to participate in a NAP and Ofgem flagged this as an area in which they are seeking stakeholder perspectives.

Individual NAPs specific to each CATO project were discussed however the general consensus of prospective CATOs was in favour of a consolidated NAP for the whole network which incorporates all TOs. Members of the group suggested the SO might be in the best position to develop the NAP as this would ensure effective outage planning, however indicated CATOs would be happy to feed into this. Stakeholders questioned whether there was a chance to look at outage planning under the STC.

**Question 4. What do you think about our proposed incentives for CATO asset management? Do you have any views on how we could best appraise asset health?**

A member of the group asked whether Ofgem would have step-in rights in the case of demonstrable underperformance. Ofgem responded by saying there is something for OFTOs, and they envisage something similar for CATOs. Ofgem indicated that they have some leverage under the license in the event of poor performance.

Ofgem stated they intend to propose penalties for poor asset management so the CATO will be motivated to comply with a certain standard; they maintained that this standard has not yet been determined. Ofgem is also proposing routine reporting (every 5 years) which could be based on something like the evaluation methodology used in network output measures (NOMs).

Numerous stakeholders raised concerns relating to customers continuing to pay for assets post revenue term when the CATO has already recovered all asset expenditure.

A member of the group indicated he would be uncomfortable with any subjective assessment of asset health but suggested asset management could be objectively incentivised if a performance bond was released under a set of thorough criteria. Stakeholders also recognised that such a performance bond would carry additional costs.

A stakeholder raised the point that after the 25 year revenue term a CATO may not be in the financial position, or willing to reinvest large sums of money on asset management. Ofgem clarified they don't want to be too specific about what happens post revenue term, but stated they expect there would be a separate regulatory process they would go through with the CATO after the 25 year period. Post-revenue term a new proposal for a defined period of time may be composed, so financing considerations may be different at this point.

Ofgem stated its potentially more likely onshore assets will be required after 25 years, therefore more stringent guidelines on asset management may be established in the future. The group had mixed views concerning this, some stakeholders felt this was unnecessary as ownership of assets by the CATO is a strong enough incentive to keep them in good condition in order to maintain the value of the assets.

A stakeholder mentioned the interconnector annual performance report is good precedent for ongoing reporting, and suggested any reporting regarding asset management could follow a similar framework to this.

There was a strong request from the group for Ofgem to provide more clarity around the arrangements at the end of the 25 year revenue term, particularly as incentives around asset management could be different depending on these arrangements. There was also a caution that we need to make sure customers don't pay twice for the assets – once in the first 25 year revenue stream and then to a second CATO for a further time period beyond the 25 years.

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

Ofgem stated that no detailed consideration had yet been done on how CATOs could recover the cost of new investment, however they outlined several potential options for future consideration by

way of example. In the first model, remuneration would be added to the revenue stream and the investment recovered within the 25 year period. They explained that this would result in an increased rate of asset depreciation and therefore potentially spike prices for customers. In the alternative model, recovery of investment would continue past the 25 year revenue term. Ofgem indicated they need to consider and consult further on what the full range of options might be.

Concerns were raised by a stakeholder regarding charging volatility to customers when recovering new asset investment. Ofgem agreed that the issue raised questions over what they refer to as intergenerational equity and what was fair to today's and tomorrow's customers. They welcomed views on this from the group.

Ofgem proposed in their consultation that the CATO has an obligation to fund necessary new asset investment to enable new connections to the transmission network. Stakeholders recognised this may restrict who can bid due to financial implications. There was also concern surrounding the fact that this potential liability was uncapped in financial terms – the costs of new connections could be almost as much as the original CATO. Potential bidders voiced they would prefer a level of certainty over their likely funding obligations during the revenue term.

Several stakeholders questioned whether funding new asset investment to enable all new connections to the transmission network would be pragmatic since a high volume of transmission works are triggered by DG. One stakeholder mentioned that the obligation needs to be flexible enough to allow for organic growth of the network. Another stakeholder suggested the CATO put up 20% of the original capital expenditure cost for asset investment to enable new connections; the rationale being that this would prevent uncapped liability. A member of the group suggested that a 'reasonable endeavours' should be considered instead of an obligation. There was a further suggestion that the incumbent CATO should have first refusal for new connections, this would then be passed onto other existing CATOs to see if they want to pick it up.

A member of the group questioned the consequences of a project which isn't electrically separable and goes over the £100m value. Another stakeholder questioned whether the CATO would be liable for this.

The group stipulated that there are a lot of unanswered questions which need looking at in more detail, for example: 'what if the requirement for new investment is outside the skillset of the existing CATO?'. The group generally agreed they wouldn't want the CATO regime to impede future connections on the transmission system.

**Question 6: 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?**

Ofgem have proposed CATOs hold a credit rating during construction in order to provide some assurance on financial robustness during construction. Several prospective CATOs questioned whether this would be a useful tool. Some commented that it could increase the likelihood of refinancing post construction. There were also questions concerning whether this would be evaluated as part of the bid.

Prospective CATOs felt a credit rating is unnecessarily costly and a 'blunt' method of assessing financial robustness. They questioned whether there were alternative methods to determine financial health of the CATO and pointed out that CATOs already have strong incentives to deliver construction of assets on time, such as the revenue term starting on completion of construction.

A prospective CATO suggested it would be helpful for Ofgem to provide detailed steps a party would go through under the regulatory framework before they reached insolvency territory. For example details on termination provisions and notice required for termination; this might be helpful context to understand what additional protections are needed.

**Question 7: 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?**

A prospective CATO expressed that starting the revenue stream earlier would reduce risk for investors and would lead to more competitive bids due to the lower cost of capital, therefore benefitting customers. There was a suggestion that the revenue stream could be phased and potentially linked to milestones.

**Question 8: What do you think about our proposal on CATO revenue (including revenue term, depreciation period etc.)?**

Ofgem is currently proposing that the assets will depreciate in the same period as the revenue term; generally 25 years with some flexibility for individual projects.

Members of the group questioned whether decommissioning costs are factored in the revenue stream and highlighted that this will need further thought.

A stakeholder highlighted the importance of considering mid revenue term expenditure when calculating CATO revenue. For example the cost of replacing scada systems and other IT and communications equipment which have asset lives significantly less than 25 years. Once again, there was a request for more detail on how these costs (as well as new connection costs) would be factored into the revenue stream.

The group reiterated concerns regarding lack of post revenue term information.

**Question 9: What do you think about our proposals of debt refinancing and equity sales? What impact do you think it would have on the cost of capital bid during the tender?**

Ofgem stated they are looking for long term investors. A stakeholder questioned the rationale behind this and why an investor would want to remain in the project for the whole revenue term.

Stakeholders suggested Ofgem should provide upfront details on how equity sales would work when there are two equity partners in a CATO and one partner sells their stake.

**Risk Allocation**

**Question 1: What do you think about our general approach to risk allocation for CATOs?**

The group had mixed views on Ofgem's proposal for risk allocation. Some felt the level of detail provided in the consultation was sufficient, others felt more clarification was needed regarding certain issues. For instance, what a CATO should do if it doesn't get access to a site.

One stakeholder commented that they may not be able to predict all efficient outage requirements at the tender stage and it is unclear who bears this risk.

Several members of the group emphasised that Ofgem need to be strict on ensuring network operators adhere to their agreement to provide open access.

A stakeholder recognised whoever takes design decisions will be liable for those under CDM until they are formally handed over.

A comment was raised regarding the additional risk surrounding access to third party infrastructure; for instance changes to network rail plans could lead to changes in network access. Prospective CATOs asserted they could only mitigate this risk to a certain extent and proposed for some thresholds to be set on additional costs to protect themselves financially from such uncertainties.

One stakeholder explained that it is customary for the construction industry to take risks and therefore would be comfortable as long as the developer carries out adequate surveying.

**Question 2: What do you think about our proposed approach around risks arising from preliminary works?**

Ofgem explained that bidders should be sufficiently incentivised to carry out due diligence to manage risks relating to preliminary works.

A member of the group asked Ofgem to clarify what they expected with regards to bidders carrying out 'effective' due diligence on preliminary works. Ofgem confirmed their initial expectation would be for the bidder to carry out due diligence using the data available in the data room and to see if there were any inconsistencies or major omissions within the data which would need to be investigated further, or factored into the bid as an assessed risk. In response to this several stakeholders raised concerns that bidders would be in a difficult position to decide how much scrutiny they should give to preliminary works when undertaking due diligence. There was also speculation surrounding whether bidders would know if there had been an amendment to the land agreements.

A member of the group suggested that a reopener around preliminary works would greatly reduce risk on CATOs, as it could potentially cover situations where information was missing or unknown. Ofgem pointed out that a general re-opener would also reduce the incentive for bidders to carry out effective due diligence.

It would also reduce the cost of capital and improve competition. There was widespread support for this on the basis it would protect prospective CATOs and therefore provide better value in the bids. There was a suggestion that the reopener included a threshold of 10-20% so that it was only triggered where there had been substantial increases in costs.

TOs were not comfortable with the idea of having to pay indemnities against information they provide on preliminary works. The work would be carried out by contractors and not themselves. They insisted it would not be reasonable for contractors to be held accountable for a proportion of the risk arising from preliminary works. A TO insisted there is an incentive for them to complete preliminary works to an appropriate standard as they could be the party who take the work forward.

The group shared the collective view that the mechanisms by which TOs can mitigate risks during preliminary works are not clear. This will need further input to ensure a high quality of work is handed over.

Some members of the group requested there be more interaction between the TO, SO and potential bidders during the preliminary works phase, as is the case under the early CATO model. Prospective CATO bidders said it would be helpful if they were allowed to stress test preliminary works. There was also a comment about what would happen if a bidder wanted extra works done that weren't provided and whether this could be facilitated as part of the tender process.

**Question 3: What do you think about the risk allocation matrix we published in our consultation? Is there anything that you don't agree with?**

The group did not provide extensive feedback on this topic but suggested the risk matrix also include preliminary works parties, CATO investors and CATO customers. There was further suggestion to split the table out for the column covering CATO and the preliminary works party.

One party noted that as long as surveys have been sufficiently carried out and access is adequately in place construction can manage other risks; they stated the key risk is accepting and managing the preliminary works. Another stakeholder suggested that the preliminary works party should carry the risk for errors and falsification, but nothing further.

Ofgem said they welcome views on where there is undue risk placed on CATOs.

**Annex 1 – Stakeholder attendees at Market Offering and Risk Allocation, 6<sup>th</sup> September 2016**

<b>Name</b>	<b>Organisation</b>
Leticia Pelizan	SHE Transmission
Paul Neilson	SHE Transmission
Alan Kelly	SP Energy Networks
Ben Graff	National Grid
Dan North	Balfour Beatty
Danny McMillan	SSE
Gary Thornton (Tentative)	Diamond Transmission Corp
Gordon Hutcheson	Ofgem
John Sinclair	Balfour Beatty
Mark Askew	Energy Networks Association
Ardy Elansei	Energy Networks Association
Ian Johnson	Ofgem
Mark Tunney	National Grid
Andy Benjamin	National Grid
Mike Lee	Transmission Investment
Paul Leddie	SSE
Saad Mustafa	Ofgem
Vladimir Ivic	Laing
Simon Deacon	Res Group
Elizabeth Lunn	Energy Networks Association
Paul Neilson	SSE

Ian Johnson	Ofgem
Peter Latham	Omexon
Petra Lenihan	Ofgem
Sally Lewis	National Grid
Amy Butler	National Grid
Henry Snow	Vinci
Samer Oukaili	Mitsubishi
Simon McVeigh	Diamond Transmission Corporation
Joanna Carter	National Grid
Joseph Baddeley	Ofgem
Matt Ball	Ofgem

## **Annex 2 – Key Terms**

Term	Definition
<b>TO</b> – <i>Transmission Owner</i>	Britain’s electricity network is owned and maintained by regional transmission companies known as TOs. Incumbent TOs are SP Energy Networks, SHE Transmission and National Grid.
<b>SO</b> – <i>System Operator</i>	Britain’s electricity network system is operated by a single System Operator. This role is performed by National Grid Electricity Transmission plc (NGET) – it is responsible for ensuring the stable and secure operation of the whole transmission system.
<b>CATO</b> – <i>Competitively Appointed Transmission Owner</i>	Where a TO is competitively appointed by Ofgem’s proposed onshore tender system, they will be known as a CATO.
<b>OFTO</b> – <i>Offshore Transmission Owners</i>	A competitively appointed offshore transmission owner.
<b>RIIO</b> – <i>Revenue = Incentives + Innovation + Outputs</i>	Ofgem’s performance based model for setting the network companies’ price controls which will last eight years. It ensures services are delivered at a fair price to consumers
<b>HSE</b> – <i>Health and Safety Executive<sup>2</sup></i>	The Health and Safety Executive is the national independent watchdog for work-related health, safety and illness.

<sup>2</sup> <http://www.hse.gov.uk/>



<b>Bolt-on</b>	Additional weightings added to the availability incentive to reinforce certain behaviours for specific projects or project types.
<b>NAP – Network Access Policy</b>	Policy designed to facilitate efficient performance and effective liaison between the System Operator (SO) and Transmission Owner (TO) in relation to the planning, management and operation of the National Electricity Transmission System (NETS) for the benefit of consumers.
<b>STC – System Operator – Transmission Owner Code</b>	The System Operator – Transmission Owner Code (STC) defines the high-level relationship between the national electricity transmission system operator, National Grid Electricity Transmission plc (NGET), and onshore and offshore transmission owners.
<b>Intergenerational Equity</b>	Remuneration spread over a speculative period over which an asset will be functionally beneficial so all potential customers contribute an equitable sum towards an asset's value