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Dear James

**Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models,
30 August 2017**

Frontier Power is an independent operator and asset manager of five OFTO assets that were competitively tendered and has been following and supporting Ofgem's proposals to introduce competitive tendering to onshore electricity transmission projects.

We are pleased that, notwithstanding the timing constraints on legislating for full implementation of the CATO framework, Ofgem is looking at innovative ways to secure the benefits from competition in onshore transmission as soon as possible.

We remain keen to participate in competitive onshore transmission projects under any suitable arrangements brought forward by Ofgem.

Our responses to Ofgem's proposals for the possible introduction of competitive approaches to delivering the Hinkley-Seabank project (HSB) are given below.

Yours sincerely,



Iain Cameron

Chief Operating Officer

CHAPTER 1

Question 1: Do you agree with our initial views on the appropriateness of the new, separable and high value criteria for the SPV and Competition Proxy models?

Response: We agree with Ofgem's view that the new, separable and high value criteria originally proposed for new transmission projects under the CATO regime are fully relevant to the SPV model.

We also agree that the separable criterion is not applicable for the Competition Proxy model. Omitting the 'new' criteria from the Competition Proxy model could widen the range of possible opportunities but we believe that, without asset transfer, the full benefits of competition are unlikely to be achieved. Applying the Competition Proxy model to existing assets would simply result in an additional form of comparative monopoly regulation and lack of clarity for both the TO and for new entrant competitors. (We comment further on this aspect in response to questions 7 and 9 below.)

Question 2: Do you think the criteria for identifying projects suitable for delivery through models intended to secure the benefits of competition should be the same, irrespective of which delivery model is used?

Response: We do not consider that the identification criteria need to be identical for different competition models. The test for the criteria should be whether they are effective in bringing about the innovation and cost-efficiency benefits of competition.

However, too great a multiplicity of competition models and bespoke criteria may result in confusion for new entrants and potential gaming by the TO which could frustrate the competition objective.

Overall, we think that the criteria as proposed for CATO are fully transferable to the SPV model.

As noted above, and identified by Ofgem, the separability criteria would not be applicable to the Competition Proxy model so use of that model would require the application of different criteria.

CHAPTER 2

Question 3: Do you agree that there is a technical need for the HSB project and that the proposed connection is compliant with SQSS requirements? If not, please give evidence.

Question 4: Do you agree with our initial conclusions?

Question 5: Are there any additional factors that we should consider as part of our SWW Final Needs Case assessment?

Response to Qs, 3,4 & 5:

We have not undertaken a detailed technical or economic review of the HSB project and its Needs Case but have no reason to believe that it is not needed or not compliant with National Grid's SQSS requirements.

We note Ofgem's questioning of NGET's proposed use of T-pylons and the estimates of additional cost involved. At this stage we have not examined the project, its routing and environmental factors sufficiently to provide an informed view of the rationale for use of T-pylons or the cost benefits of the alternative lattice towers. Given that NGET undertook a design competition to create the new T-pylon, we would assume the development costs should be borne by NGET as a whole as part of a broad innovation programme and not that this project should not be burdened by all of the 'first-of-a-kind' development costs. Equally, we assume that NGET holds the design rights of the T-pylon, which may enable an SPV to tender for lower costs of fabrication and continuous improvement of the design to allow similar evolution and cost reduction as has been seen in OFTOs.

We note that the DCO for HSB was issued based on the use of T-pylons for part of the route. If the SPV model is adopted it would be critical for investors to have certainty that the project could be developed under the existing DCO (*as noted in para 2.17 of Ofgem's consultation*). If Ofgem requires an alternative technical solution to that on which the consent is based then investors in the SPV would require full assurance that there would be no implementation delay resulting from that change. We also assume that the DCO contains specific protection from becoming time expired and allows sufficient time for any environmental studies or monitoring, such that a delay in tendering would not cause a delay to the overall programme driven by a failure to implement monitoring at the correct time.

With reference to the Thames Tideway Programme, DCO compliance, land and consent rights (along with relevant statutory and non-statutory compensation) and certain enabling and system works remain the responsibility of Thames Water. The SPV would need to see a similar clear delineation of rights and obligations along with licence obligations for NGET to co-operate and collaborate in any obligations retained by NGET.

CHAPTER 3

Question 6: Do you agree with our assessment of HSB against the criteria for competition, including our view on potentially re-packaging the project so that it meets all the criteria?

Response: Yes, we agree that HSB as re-packaged clearly meets the high-value, new and separability criteria.

We have previously commented to Ofgem (FP response, 11 January 2016, to Ofgem's CATO proposals) *'that electrical separability should not be required at each interface'* and we agree that, for HSB, such interface points, *'can be managed in line with normal industry arrangements'* as proposed in para 3.5 of the present consultation. Indeed, we have experience of satisfactorily managing OFTO asset boundaries for OFTOs that are not electrically

separable without dismantling equipment. As long as responsibilities across the boundary can be defined clearly in a Site Responsibility Schedule, then the exact location of the ownership boundary is not an issue.

The proposed re-packaging of the HSB project seems entirely in keeping with Ofgem's November 2016 decision document in that, *'the vast majority of a project proposed is brand new or a complete replacement, but a small proportion involved updating/renovating existing assets'*. It will result in an overall project that meets the new, separable and high-value criteria and should be attractive to potential investors.

Question 7: Do you agree that the SPV model or Competition Proxy model would deliver a more favourable outcome for consumers relative to the existing status quo SWW delivery arrangements under RIIO?

Response: We agree that both models have the potential to deliver consumer benefits compared with the existing SWW arrangements.

We believe strongly that the SPV model is significantly more likely to deliver benefits at the upper end of Ofgem's estimated range.

The SPV model is closer to the CATO model and broadly comparable to the OFTO model which has led to material reductions in the long-term costs of those projects. These have come from optimised financing arrangements, including the cost of equity, debt, appropriate risk apportionment and insurance as well as innovative contractual operational arrangements and have exceeded Ofgem's initial expectations. It is reasonable to expect that similar benefits could be delivered from the SPV model but it is not clear to us that the Competition Proxy model would deliver comparable cost-savings.

The advent of competitive onshore transmission opportunities in the UK is likely to present an attractive investment opportunity to new entrant asset managers and we believe it would create sufficient interest to drive very real overall cost reductions to HSB and subsequent similar projects under SPV or, eventually, CATO models.

By contrast the Competition Proxy model will not take advantage of the benefits brought into the sector by new entrants. Reductions in WACC and implied gearing ratios can be imposed by Ofgem on NGET based on benchmarking from other projects but essentially this remains a form comparative regulation which will be subject to challenge and uncertainty as to whether optimum outcomes have been reached. It will also reinforce the current asset ownership model and discourage new entrants and the innovation that they could bring. It might also increase construction and operational risk if costs are inappropriately cut to meet imposed levels of return on capital. The cost of capital should encapsulate a project's financial, commercial and technical structure not be an imposed input.

Only the SPV model will fully reveal the competitive benefits that could be obtained and provide the price discovery which Ofgem would like for future price control setting.

Question 8: What are your thoughts on the SPV model, including:

(a) The structure of the model and length of revenue term?

Response:

Structure

SPV Approach

Project specific SPVs have worked well in reducing the cost of delivering OFTO transmission services and we see no reason why such an approach could not be successfully applied, with similar results, to on-shore transmission projects.

A critical consideration for Frontier Power is the security with which income will flow from NGET to the SPV and the clear definition and allocation of risks and incentives. Our OFTO experience, and what we have observed with the Scottish TOs and in other comparable infrastructure regulatory regimes, is that a clear, structured, revenue flow is key to securing the best financing deal. The statements in para 3.15 and appendix 3 are encouraging in this respect though obviously the detail of the Delivery Agreement in setting out exactly which risks and what incentives or penalties (e.g., construction completion or availability-based) would apply will be critical.

We recognise that more work needs to be done in defining the Delivery Agreement and risk allocation between NGET and the SPV but we would very much like to see the widest possible remit given to the SPV's procurement role if the maximum benefits are to be obtained from the SPV model. This would mean limiting those contracts which NGET lets before the project is transferred to the SPV to those whose early ordering is absolutely essential to meeting the project programme.

As stated above, there would need to be a clear delineation of rights and obligations between NGET and the SPV. Ofgem quotes the Thames Tideway project, which was put into effect using the Water Industry (Specified Infrastructure Projects) Regulations 2013, which along with the relevant project specification notice and relevant licence conditions clarified the rights and obligations of the infrastructure provider with the incumbent utility. The applicability of the Utility Contract Regulations (UCR) and the extent to which the infrastructure provider was required to tender. An elongated SPV procurement process and or requirement to follow the UCR or lack of clarity of applicability, may restrict bidders, reduce potential consortium bids and create risk and uncertainty for funders.

Our OFTO experience leads us to believe that there is real cost and timing benefits from bidders including financial commitments as part of their bids at the ITT stage and would like to see it included in the SPV model. However, in order to do so the extent of the risks and opportunities need to be clearly laid out at ITT stage.

Continued NGET involvement with the SPV

One structural issue we would like considered further is the need for NGET to retain, 'the regulatory responsibility for delivering HSB and operational control of the transmission assets' (para 3.14 and appendix 3). This runs counter to the successful OFTO model where assets, transmission licence and regulatory responsibility are all transferred to the OFTO SPV. If this is necessary because current regulation and legislation would not permit such a transfer then Ofgem will need to consider very carefully how conflicts of interest can be managed under such an arrangement whilst securing the maximum benefits which less constrained SPV financing, operational and construction innovation could bring.

Similarly, Frontier Power is unsure that there would be any real benefit from NGET retaining an equity interest in the SPV. Any possible incentive benefits from NGET involvement could easily be outweighed by the additional managerial complexity and necessary management of conflicts of interest. No such arrangement has been used in the OFTO regime and we are not convinced that it is necessary here. If NGET needs to be incentivised to ensure effective tender and project delivery then we think this would be better done via a defined percentage of savings achieved from the SPV model.

In operation and maintenance of any line, then certain matters may be better delegated to NGET on a cost transparent basis as it may be more cost effective to monitor and utilise utility access rights than the SPV. Outages would need to be managed by the SO and so licence conditions to facilitate access and ensure that the SPV's assets are preserved. The integrity and safe operation of the SPV's assets will be largely dependent upon the SO's behaviour.

Consideration should also be given to insurance costs and risk allocation. NGET will have the ability to self-insure via its captive, which would be preferable to a contractor controlled insurance policy. The transference of large or unquantified risks or consequential losses will create additional costs for the SPV. Therefore, risks and costs should sit in the places most appropriate to be borne whilst an appropriate and proportionate incentive should be placed upon the SPV.

Governance of the Tender Process

Independence of the Tender process from NGET's TO business will be critical to ensure confidence in the process. We assume that Ofgem envisages working with NGET's SO in establishing and running the tender process. Ideally, such a process should be run by a fully independent SO. However, we recognise that an independent SO is not compatible with current timescales and therefore welcome Ofgem's intention to oversee that process.

There are useful precedents to draw on in designing the tender process such as that run by the Alberta Electric System Operator (AESO) for the Fort McMurray West 500 kV Transmission Project on which Frontier Power advised the winning consortium (APL). (The winning bid price (which included lifetime O & M costs) was Can\$1.43bn compared with the original incumbent

TO price for capex alone of Can\$1.8bn.) That tender process was substantially outsourced to PWC and Norton Rose so, if NGET is unable to manage the process because of resource constraints then viable alternatives are available.

Similarly, there is UK experience to draw on from competitive tender for the Dounreay to Shetland cable run by the SSEN earlier this year and won by National Grid.

Length of revenue term

We think it is worth Ofgem considering longer revenue periods than 25 years. Onshore transmission assets typically have design operational lifetimes of forty years or more. The Fort McMurray Transmission Project has an operational revenue period of 35 years, and including the consenting and construction period the concession is for approximately 40 years. We would like to see Ofgem re-visit its earlier CATO work to see if its conclusion that the shorter, 25-year revenue period, '*delivers the best value for consumers within the debt and equity markets*' (par 3.16) is still valid.

(b) Should construction funding start during construction, or once it has completed?

Response: Funding during construction has the potential to reduce some infrastructure parties' financing costs as occurred during the Thames Tideway tender process but is not essential to securing competitive bids. It was not available on the Fort McMurray tender which was highly competitive with five separate consortia entering the final bid stage.

The Thames Tideway project allows for funding during construction, which would create certainty of any debt service costs, which would potentially lower overall WACC. It would also remove the risk of delayed commencement of the revenue term should the Hinkley Point project be not ready for operation. NGET has the benefit of balance sheet funding at a Group level, whereas funding a single asset with unclear risks and revenue stream will mean a higher degree of risk will need to be accounted for so creating a higher WACC. The Tideway project provides government protection around outturn cost, financing and insurance over the term should it be required, which enabled bidders to become more comfortable with the risk profile and enable lower WACC.

(c) The contractual and regulatory arrangements?

Response: Our views on the Delivery Agreement, contractual, tender process and regulatory arrangements are set out as part of our answer to Q.8(a).

(d) The identified benefits?

Response: We agree that significant benefits can be obtained from reductions in the cost of capital that a well-structured SPV model could bring. Additionally, we believe that there are material benefits to be obtained from competitive delivery of construction and operational activities. This has been well-demonstrated by successive improvements in OFTO operational bid costs and

we strongly believe there are similar cost reductions to be obtained from an SPV-managed construction procurement. Those benefits are likely to be larger the earlier and greater the SPV can be involved in the design and procurement process.

We also agree with Ofgem (para 3.41) about the longer-term consumer savings benefit which will arise from having proper price discovery of transmission activities which an SPV model, as a precursor to CATO, could provide.

(e) Any potential downsides or implementation risks?

Response: We have not identified any specific downsides to the SPV approach provided roles and risk are clearly defined and allocated and income secure.

Ofgem's desire to progress the SPV model tender process on a timescale commensurate with the project construction programme is encouraging but may bring some risks if the tender process is not well-designed and governed. There is insufficient detail in figure 2 for us to be certain how these issues will be managed but we would stress the importance of tender programme design in achieving the objectives for the reasons set out in answer to Q. 8(a).

We would welcome the opportunity to comment in more detail on this aspect if Ofgem consults again on this model in its envisaged further consultation in December.

(f) Any other considerations?

Response: No comment.

Question 9: What are your thoughts on the Competition Proxy model:

Response: As we have said in response to Q.7 we do not support the introduction of the Competition Proxy Model. In our view it does not introduce real competition to the transmission market, will not provide the same level of cost-savings nor the price discovery benefits of the SPV model and cannot be seen as a step towards a full CATO regime.