Infracapital

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Dear James,

Hinkley Seabank – Consultation on Final Needs Case and potential delivery models

Please find enclosed our response to the Hinkley Seabank consultation.

For ease of reference this summary outlines our general views, which are expanded within the responses to the questions overleaf. In summary:

- As we have previously communicated through the consultation on the proposed CATO regime, we agree that there is value to the consumer to be gained from a competitive process for large onshore transmission schemes.
- We agree that this value and optimisation could be gained through the SPV Model. We are not convinced that the Competition Proxy Model adds value.
- Whilst being supportive of the SPV Model, we are concerned that the need to maintain and meet the current connection dates for Hinkley are such that the only realistic way of securing a supply chain and meet the required programme is through the utilisation of National Grid's existing Framework Agreements.
- We have concerns that given these Frameworks were not designed for this purpose and that, if this was the case, there is a potential to erode any potential increased value that might be derived from adopting the SPV approach in particular. Modification to the frameworks to allow partnering across the frameworks should therefore be discussed with National Grid.

If you have any questions or would like to discuss further please do not hesitate to get in contact.

Yours Sincerely,

Infracapital

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?*

In principal yes and as per previous consultation on CATOs we believe there should be some flexibility on the "new criteria" where interfaces can be optimised.

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?*

Yes

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

There is a need to connect the HPC to the Transmission Network, the HHSB scheme presented by NGET appears to address the need and the TNEI study commissioned by OFGEM confirms this scheme, as presented, is compliant with the SQSS requirements.

Without further detailed information it is not possible to comment whether the scheme represents value for money, given the need for NGET to consider issues such as future constraint costs and future capacity requirements – we trust that this has correctly informed the decision to discount alternative technologies such as HVDC which might be considered more cost effective if considered in the context of the HPC only. Neither are we able to comment whether a different approach to addressing the issues of visual impairment may have represented better value.

Question 4: *Do you agree with our initial conclusions?*

We agree:

- There is a need for a 400kV transmission connection and that based on the available evidence the connection scheme proposed satisfies the need.

- The underlying costs of the scheme require review, as the costs for some elements of the scheme appear to be low in comparison with other similar schemes delivered in the UK. However, we do recognise that the delivery competition process will be used to set the market price.

We believe that further consideration needs to be given to:

- The additional costs of T-Pylon production and installation versus lattice pylons. NGET's undergrounding proposals.

- The need to review and refine the overall risk budget for the scheme

- The need to engage with the DNO.

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

The final needs case analysis should consider the extent to which the SWW procurement methodology, employed by NGET, mitigates the interface risks between the package contractors. Furthermore, early consideration should be given to the engagement with the NGET supply chain partners to establish the commercial framework for delivery, if that is to change from NGET's current plan.

If NGET intends to commence the supply chain procurement programme before the consultation process has concluded, this presents the risks of reducing opportunities for alternative delivery strategies and innovations, as well as increasing supply chain tendering cost. We might expect the supply chain engaged through the existing frameworks to be concerned that tendering effort and associated costs may be duplicated if this process is subsequently superseded as a result of this consultation outcome.

There is merit in NGET's concern that the supply chain process cannot be delayed if the current HSB connection dates are to be maintained.

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?*

Yes. The repackaging of the short overhead line section which reuses an existing pylon line appears sensible albeit not critical in the context of the overall scheme.

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?*

We agree that a SPV approach would allow experienced delivery partners to come together with experienced finance providers to co-ordinate an integrated delivery solution aligned with an optimised funding solution, maximising the value to the consumer, by addressing the opportunities identified below.

The current approach adopted by NGET, is to procure three separate contracts through the existing framework agreements which does not necessarily deliver best value for the consumer given;

- A number of physical and programme interfaces are formed leading to increased risk and opportunity for contractual variations. This risk could be passed to a single delivery entity that in turn would be more able to manage these risks.

- Each framework contract requires a civil sub contractor and therefore the current NGET framework agreements do not provide an opportunity for the project to benefit from the scale and knowledge of sharing a single civil contractor for the project as a whole.
- Given the scale of the civil engineering element of the project, it would be beneficial to have the civil contractor as a delivery partner, rather than as a sub contractor, to reduce contingency on contingency. This is not possible under the current NGET framework.
- The current framework approach does not support an integrated solution for the project, which is likely to have significant project limitations, in particular in managing the specific requirements related to the DCO.
- A single delivery entity would be able to coordinate key risk items such as land access.

Overall, the SPV approach allows organisation(s) with a recent successful track record in the delivery of large complex projects, to manage the delivery of the project.

Question 8: *What are your thoughts on the SPV model, including:*
(a) The structure of the model and length of revenue term?
Overall, we concur with the proposed model in that the SPV would finance, construct, and operate HSB under a delivery agreement with NGET for a fixed revenue term, and such a model would support an integrated and more appropriate delivery of the project. We would also recommend that the SPV competition covers the widest possible scope, i.e. that the competition invites bidders to procure all the contractors/sub-contractors for construction and operation of HSB, and all the associated financing (debt and equity) and submit their proposals in relation to all these areas at the ITT stage. This will support efficiencies through holistic delivery of construction, operations and financing, and ensure that competitive pressure is brought to bear on all these areas, as outlined in the response to Question 7 above.

This approach to procurement will;
- support partnering (enabling an integrated single delivery solution);
- reduce contractual layering and associated margins and contingencies (in particular for the delivery of the civils elements) and;
- allow new market participants not currently on the framework agreement to participate on the project; and
- support the creation of a bankable contract with external investors.

It is recognised that a) this may not be possible under the NGET framework agreements and b) that if the timescales for the HSB connection are to be maintained the time to conduct an SPV competition allowing the SPV tenderers to procure contractors / subcontractors for construction, is challenging.

The Consultation is also slightly unclear on the role of NGET setting up the SPV and procuring contractors and subcontractors. We would recommend that the SPV consortia have the sole responsibility to contract delivery partners/contractors and establish the legal SPV entity. The benefits of NGET's initial involvement over the additional procurement and contractual complexity this may bring, are unclear and may be driven by timescales and the need to meet the current contractual dates for connecting Hinkley. This in itself we believe is not sufficient reason given there are also risks which both the delivery partners and / or SPV would have to consider. These might include for the delivery contractors, the risk profile of being requested to partner with other contractors to enable the delivery of the whole project scope – these partners may not necessarily meet the partnering selection criteria for a project of such scale and complexity and this risk would be priced accordingly, notwithstanding that these partners may be restricted to those currently identified by the existing NGET Frameworks. For the SPV, these risks may manifest themselves in the fact that the timescales do not allow the SPV to select their preferred delivery partners given this selection and partnering may be project managed by NGET – this risk may also be factored in by any selected SPV.

As referenced above, we would recommend that the tendered revenue stream should include the cost of debt to encourage innovative debt solutions. The PB period should be sufficiently short that the price of debt can be fixed.

With respect to the revenue stream, it would be preferable for the consumer, if the revenue term was aligned to the economic life of the asset, i.e. 40 years. In consideration of the size of the project and the availability of long term project bonds, a review of a 25 year revenue term and a longer revenue period should be considered.

(b) Should construction funding start during construction, or once it has completed?
It is recognised that the commencement of the revenue stream following energisation of the transmission assets will provide clear financial incentives for the SPV to complete construction without the need for complex incentive mechanisms. However, in consideration of the project's large capex and long construction period, liquidity problems may justify pre-funding. Pre-funding should therefore be assessed further.

(c) The contractual and regulatory arrangements?
We concur that it is reasonable to believe that competitive tendering will provide sufficient pressure for tenderers to bid economic and efficient costs. The Delivery Agreement (DA) will clearly play an important role in determining the competitive appetite of delivery partners, investors and the debt markets. It is therefore important that DA is developed in consideration of the optimum risk sharing arrangements maximising benefit to the consumer. Consideration of specific risks with capex and project delivery which NGET should retain, may include

- FOREX and Brexit
- Unexpected ground and contamination risk
- Unusual weather risk
- Change in design, standards and specifications
- Changes in law
- Changes in consent, planning conditions

Ofgem along with its advisors will need to play an important role ensuring that the DA is developed with an optimum risk allocation to secure the benefits of private sector participation.

In this context, we recognise that further thought needs to be given to the role of NGET and associated conflict of interests. The benefits of NGET participating in the equity of the SPV are not clear and we believe that this may create a conflict of interest for NGET, in particular with the resolution of any commercial contractual issues. NGET need to be incentivised to ensure that the model is a success and delivers best value money for the consumer.

It is our expectation that the DCO will contain and impose a number of delivery limitations on the project, such as vehicle movements. An SPV model creates an opportunity for a single delivery entity to take responsibility for the collective management and compliance to these obligations across the project, minimising any sub-project interfaces and subsequent contractual issues. On this basis we believe that the DCO requirements should be managed by the SPV and not NGET.

(d) The identified benefits?
[see response to question 7]

(e) Any potential downsides or implementation risks?
As we have articulated in Question 7 and earlier responses we see the primary implementation risks being, not in the SPV approach itself but, in the required timing of the appointment of an SPV and a competent supply chain given that this may necessitate the selection of the supply chain through either existing NGET procurement processes or derivatives thereof.

(f) Any other considerations?
We are concerned with the overall timeframe to reach Financial Close in 15 months, assuming the tender process commences at the beginning of 2019. In particular the Preferred Bidder period of 3 months is probably too short to reach Financial Close, and should be at least 6 months. A potential mitigation for this is for NGET, under the current framework procurement process, to allow tenderers to come together and initiate partnering discussions in lieu of the SPV procurement process.

The consultation makes several references to Thames Tideway. Whilst Thames Tideway has been delivered through an SPV approach outside the relevant regulatory framework, we do not consider it to be necessarily a comparable model for both the approach to procurement and delivery, as well as WACC. Primarily due to the fact that Thames Tideway project;

1. Spent a significant amount de-risking the project (e.g. ground investigation), which is not the case with HSB.

2. A cost guarantee was provided by Government over and above the agreed contingency funding.

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

We do not believe a Competition Proxy Model will truly test the benefits of an integrated SPV procured position as intended and is therefore of limited value.