Appendix

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 general, as explained in our covering letter we believe firmly that the extension of competition in transmission is best underpinned by primary legislation. Ofgem has been consistent is also taking that position. Whilst we appreciate that primary legislation has been delayed, our view remains that primary legislation is necessary if we are to deliver to end customers the potential benefits of competition. The proposed approach is insufficiently thought through and the lack of a stand- alone consultation under states the challenges involved and the significant impact that the market change would have on affected stakeholders, including end customers. We note here that the criteria have previously described by Ofgem as "*draft criteria*", with secondary legislation required before they could be taken forward. We would appreciate more detail on Ofgem's decision to move forward without secondary legislation.

Concerns about Ofgem's approach notwithstanding, the definitions of new and separable are reasonable. It is important to note that where assets are not electrically contiguous, and an overall project package may be split to create a coherent package for development and tendering, the definition of the "project" is a key consideration for consenting purposes under the Environmental Impact Assessment (Scotland) Regulations 2000. Any associated Environmental Statements that support a consent application will have to consider the impacts of the defined project and where this covers multiple elements with multiple parties (existing TO, SO and the successful bidder under the SPV model), cumulative impacts may have to be considered which adds significant complexity to the process. The responsibilities of parties in this respect will have to be carefully examined, particularly in the event of a Public Local Inquiry.

We continue to be concerned about Ofgem's proposal to set the high value threshold to £100 million across GB for RIIO-T1. Ofgem's proposal means that works in Scotland valued between £100 and £500 million could be subject to competition, whereas an identical project in England and Wales would not be. In our view, unless the high value threshold is set at the same monetary value across GB then the competitive process will be discriminatory. We would once again urge Ofgem to carefully consider the consequences of its proposals in this area.

With regard to the history of the different SWW thresholds, whilst we accept that our SWW threshold was proposed by us as part of our RIIO-T1 Business Plan, we have also previously explained the background and timing of this relative to submission of our revised Business Plan and the first mention of the potential for SWW projects to be competitively tendered[1].

We note and welcome the flexibility in other aspects of Ofgem's proposed approach. We would agree that where the extension of competition would lead to a critical delay in meeting a project timeline then this may be considered as an argument for the status quo i.e. a TO led approach, which is already subject to competition requirements pursuant to the Utilities Contracts Regulations 2016 (and equivalent regulations in Scotland). Similarly, we welcome Ofgem's

[1] SSE letter, 2015-07-10 SHE Transmission response to Criteria consultation JC.pdf

recognition that there may be issues specific to the project that mean the extension of competition would not be in the interests of customers. We note that Ofgem has shown flexibility in complying with its own draft Guidance on Strategic Wider Works in relation to the lack of an Initial Needs Case (albeit in lieu of work already undertaken) and we hope that such flexibility and adaptability to the requirements of a project is indicative of Ofgem's commitment to a pragmatic approach going forward.

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?

The criteria which will ultimately to be used to identify projects suitable for the extension of competition should be the same irrespective of which model is applied to give effect to this extension of competition. However, we believe that there must be a prior step, whereby Ofgem is able to draw on Parliamentary guidance and debate as to whether Parliament intended that competition be the preferred intervention under the particular set of circumstances in question. Otherwise, there are risks that Ofgem's approach could be in conflict with other critical energy policies.

The suggestion that the competition proxy model could be applied to projects which are not new would be at odds with Ofgem's previous position on CATO, where there was no suggestion that projects which were not new would be subject to competition. Such an approach would represent a significant change in direction for Ofgem, fuelling yet more uncertainty amongst stakeholders. Moreover, the possibility that projects which are not new could be subject to an extension of competition would be contrary to the principles of the RIIO – T1 agreement. Ofgem has not provided any justification for it being appropriate to adopt a different approach to the criteria for identifying projects suitable for extending competition.

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

The SWW guidance document has not yet been finalised or formally consulted upon (we have asked for but not yet received an explanation for Ofgem's approach to revising the SWW guidance document). Under the current process, which relates to Special Condition 6I of the Electricity Transmission licence, there is not an initial and final needs case, and there is no competition assessment. We understand however that Ofgem is working in accordance with the draft SWW process. Given this has not yet been formally consulted upon for consistency of approach across the TOs, we would suggest maintaining the status quo, and following the SWW process which TOs are obligated to follow under licence. As mentioned during the last informal review of the SWW guidance document amongst the TOs (May 2017), our review was on the basis of the CATO regime and primary legislation being introduced; we suggested that as work on competition was incomplete, the SWW guidance was difficult to review, and this difficulty still applies in respect of the new models Ofgem has proposed in this consultation.

Despite this, we do believe there are additional factors which should be considered in the revised SWW process, which Ofgem has followed in the consultation, regarding the tender process, supply chain and the timing of the introduction of the SPV model.

As outlined in our previous response (the development of competition for onshore electricity transmission assets, dated 15 July 2015) and in our informal review of the SWW guidance (May 2016, see section 3.23) we continue to have reservations regarding the tender process and supply chain engagement working in parallel. We note the indication in this consultation that a project will be assessed for competition during either the initial or final needs case for the proposed new SWW process. We would stress that the delivery and cost of projects could potentially be impacted by the uncertainty around the potential for projects to be subject to competition at two different stages and potentially being contracted to a third party following a competitive process. Ultimately, the costs which result as a consequence of these uncertainties will be borne by end customers, the shape of delays or higher costs.

Uncertainty around being assessed for competition at two different stages may deter contractors, who would have to incur significant bidding costs, from participating seriously and revealing accurate costings, and could potentially skew the tender process. This approach will not provide the most efficient solution and inadvertently impact the consumer benefits of competition, potentially resulting in additional costs and impacting the delivery. Based on our experience, we believe that earlier supply chain engagement is essential to support the consenting process in particular and consideration of the design and constructability aspects of the project. While some of these aspects can be addressed by engagement of independent third parties, the engagement of the actual party constructing the asset can be a critical factor in securing consents for the project which would remain the responsibility of the TO in the SPV model.

We support Ofgem's flexible approach to the proposed SWW process and note NGET's fast track to final needs case, as well as the shorter consultation timescales (6 weeks instead of a minimum of 8 weeks as stated in the SWW guidance). We welcome the flexibility and understand from the latest draft of the SWW guidance (page 7 and 19) that the timetable would be specific to each TO's SWW project.

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?

In our previous response, regarding the North West Coast connection, we responded that the project met the criteria for assessing competition on the basis that Ofgem had acknowledged the assessment criteria was dependent on the necessary regulatory framework being in place. This included the draft criteria being agreed and consulted upon before being emplaced in secondary legislation; we note Ofgem's approach has changed significantly and the criteria is now planned to be drafted in a way Ofgem sees fit. As outlined in our covering letter to this response, we have serious concerns that the proposals are ahead of legislative change to extend competition in electricity transmission.

Notwithstanding the above, we agree with Ofgem's assessment that the HSB connection (excluding small section which is not considered 'new') is potentially capable of being open to competition. The treatment of HSB in this consultation appears to be in line with the policy by which Ofgem expects to decide whether or not to tender project as set out so far in the HSB consultation document.

We note the small section of assets which is not considered 'new' would be funded through another RIIO-T1 mechanism or as part of RIIO-T2. We would welcome clarity on how assets which are not packaged as being part of the competition process and do not reach the SWW threshold are funded without impacting delivery dates as co-ordination between the re-packaged projects will be essential in meeting delivery deadlines.

We also note the DNO works are being included in the re-packaged project, we do not think that this is necessary given the connections market for distribution connections is already subject to competition in accordance with the standard licence conditions of DNOs. This was following a review of the connections markets and a competition assessment on each DNO's different market segments. Any contestable connections work, in accordance with each DNO's Connection Charging Methodology, would be subject to competition in which ICPs would be able to compete for the works. We would also question why DNOs costs, which are out with the TO's control would be included in the SWW project and whether these costs should be included in the 'high cost' criteria when assessing projects for competition.

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 have demonstrated through the RIIO – T1 period a track record for delivering complex projects, many of which carry significant risks, on schedule and within agreed allowances. Customers have benefitted through the sharing mechanism under the terms of the price control. TO's are already subject to competitive requirements by virtue of the Utilities Contract Regulations 2016 ('UCRs'). We have consistently shown how the current approach under the RIIO framework provides powerful incentives for efficient delivery. Regulated tender processes pursuant to the UCR delivers efficiencies through our contractor supply chain, so the extension of competition could potentially deliver only incremental gains at best. We do not have sufficient information on the impact on consumers of either of the models proposed for any such conclusion to be reached. We are not aware of any other research on these models, but would be happy to review Ofgem's Regulatory Impact Assessment (RIA). As the experience of our Distribution colleagues with the SPV model in Shetland has shown, it is far from straightforward to execute the extension of competition and there are costs and contingencies which Ofgem's RIA will have to take into account. We feel that, should Ofgem be minded to move forward with plans to extend competition without recourse to primary legislation, then the competition proxy model has the potential to offer a lower risk step towards full competition, which would allow the wider supply chain to adapt business models and Ofgem to improve it's understanding of the practical challenges involved. This should not be interpreted as a positive statement in favour of the competition proxy proposal, as we have insufficient

detail as to how it would operate in practice, but it would appear to involve fewer of the kinds of risks that would ultimately impact end customers through delays and higher costs.

8. What are your thoughts on the SPV model?

Our comments below are general in nature and National Grid is best placed to comment on the specific details of Ofgem's claimed benefits. However, we do not feel that the practical challenges of making such a mechanism work (and the corresponding consequences for end customers) have been given sufficient weight in the published analysis.

a. The structure of the model and length of the revenue term

As a general point, it is unclear whether a contract for as long as 25 years would be accepted under the terms of EU competition law. We would appreciate Ofgem sharing its legal advice on contract duration. We note that the proposed 25-year revenue recovery period against a 40-year asset life would give rise to a situation whereby Ofgem believes that the asset would have zero regulatory value, but the TO may yet have to fund the operation and maintenance of the asset for up to another 15 years (or even more). Ofgem have not made clear how this additional cost to the TO is to be funded, such that customers do not face being over-charged for assets. We do have concerns about how such a regime will work and believe that an expert industry working group must be set up to design and agree the detail of the regime. If a residual value is to be considered appropriate, then this should be equal to the net book value of the Regulatory Asset Value (RAV) of the investment as opposed to any proposed 'bid' residual value. This would ensure a consistent application of costs to consumers over the life of the asset in line with current RIIO arrangements.

In addition, we note that although an alternative approach, retaining a 40-year revenue recovery period is in line with the current RIIO framework for T1, the BGT appeal to the CMA and the subsequent final determination indicates that a review of the 40-year asset life may/will come under review by Ofgem. In the event there is a revision to asset lives in advance of future price controls, there may be a need to revise the revenue recovery period to ensure the balance of charges is equitable between different generations of customers (thus ensuring intergenerational equity). We believe this uncertainty should be resolved prior to setting the financial parameters for cost recovery for the proposed extension of competition particularly given the intergenerational implications.

We believe that Ofgem needs to consider the cost to customers that may arise as a result of an 'aged' asset (being 25 years old) requiring refinancing by the TO and whether this may lead to increased financing costs and operational and maintenance costs. We believe Ofgem should undertake analysis on a range of potential 'feasible' options and consult in sufficient detail to inform a wider discussion; otherwise this may become an issue for future customers.

Additionally, the 25 year break point may result in a substantial number of assets being transferred to the current regional TO at the end of the contract period. Unintended consequences of a break point may result in poorly maintained assets being transferred to the regional TO along with the operational risk. If, as Ofgem proposes, these assets

have zero regulatory value there is a funding gap in relation to the cost of ongoing maintenance and operation. A residual value is only appropriate on the basis that the underlying value of the asset is in the appropriate condition and no impairment of the RAV would be required. As Ofgem has noted previously in relation to CATO, some form of guarantee (Ofgem state some form of a "performance bond") would be required to ensure customers were compensated for poorly maintained assets. Such a condition may constrain investment or increase the cost of financing due to the increased end of period risk associated with the asset condition. The type of protection must be further developed, particular to ensure consistency across the sector.

We believe that the risk management of these assets on behalf of customers is therefore critical to mitigate poorly managed assets being transferred to TOs. If Ofgem believes that the TO should undertake this risk management function, then there will need to be clarity on how this will be remunerated. We also believe any risk of financial distress must be forefront of the framework similar to under RIIO. Third parties appointed through the SPV process will need to be of a similar scale, financial standing and size to fully regulated NWOs in their own right and owners/operators of critical UK infrastructure. As a minimum, we encourage Ofgem to adopt a regulatory framework for these operators in line with the current obligations for existing TOs, whereby the licence obligations are consistent. This would include applying elements such as financial ring-fencing, provision of regulatory information, data assurance requirements, and required to maintain investment grade credit rating.

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

There are potential costs and benefits associated with either approach, so the question would be best addressed on a case by case basis. For instance, where payments are scheduled to commence on the services start date there an incentive to deliver and be on time, but this approach could also result in the service provider including a cost premium for the non-recovery during the construction phase. Releasing payments throughout construction may serve to lower barriers to bidding as it may reduce bidding risks. However, where payments are made before completion there are obvious challenges for the TO (and ultimately end customers) where an asset is not delivered and yet costs have been incurred.

c. The contractual and regulatory arrangements

Ofgem suggests that, under the SPV model, contracts may have to be novated to the successful bidder. In practice, this may be more challenging that the consultation suggests. We have discussed previously our concerns regarding transfers of property rights and consents, and the different regimes in Scotland versus England & Wales.

It is important to recognise that there are differences in planning/consenting arrangements and legal jurisdictions that may preclude transfer of assets, such as wayleaves and land agreements in Scotland. It is our view that a detailed review of issues in this area is undertaken as it may be necessary to change the current approach and seek

agreement on changes with the relevant statutory and consenting authorities. This review needs to be put in hand as a matter of urgency.

Another challenge relates to the development, preparation and submission of Environmental Assessments (EA) and Statements (ES) in support of a Section 37 or Planning application, in line with the requirement under the Environmental Impact Assessment (Scotland) Regulations 2000 (EIA). These are key documents in the consenting process and are supported by significant stakeholder engagement. More often, details of the construction processes (which requires early input of the party constructing the asset) and specific mitigation measures to be deployed on the project must be included. In our experience, this is rarely a straightforward task and would be made more complicated when the party responsible for constructing the asset (the successful bidder) is not engaged. Clearly, it would be better to involve the successful bidder in this activity, but this will add to the timeline for project delivery. The consideration of such a document in the consenting process often drives the conditions that are then attached to any granted consent.

The definition of "The project" under the EIA is an important consideration in any ES. If scope is broken up to allow elements of competitive tendering along with some project scope remaining with the TO, the process for securing consents will become more complicated and drawn out.

Depending on the project phase, not all consents may be secured before the successful bidder is appointed. In the event that a Public Inquiry is called or a compulsory wayleave hearing is requested to determine the outcome of a consent decision, the responsibilities of parties will have to be clearly defined. It is possible that, both the SO and SPV will have to cooperate and both be represented to cover the various aspects of challenge. Depending on the status, it is likely the SO will play a larger part in this given its role in justifying the Need and also the design solution.

We have significant concerns at the practicality of Ofgem's proposal that the third party is unlicensed and would somehow operate under the terms of the regional TO's licence. A considerable amount of further work is required by the industry and Ofgem before the compliance risks in this approach can be fully quantified. It is not currently clear how liability for all regulatory obligations can be addressed through a contracting process, as well as how the transactions costs incurred would be apportioned. We believe it unlikely that any third party (as envisaged under the proposed scheme) would be prepared to indemnify a TO for the potential loss of its licence due to a compliance failure on its part. Short of a complete indemnity model, the uncertainty around timetables for negotiating what would be a highly complex set of contracts would ultimately create considerable delays and uncertainties for the very customers Ofgem is seeking to serve. Our strong preference is for the extension of competition to be supported by primary legislation, through which a much more appropriate licensing model could be adopted.

The application of a consistent, robust, and fair regulatory framework should be in place for all those who operate and maintain transmission assets. This would ensure that all operators fell within the regulatory oversight and apply the same regulatory practices as

required by all regulated networks. This would provide Ofgem with the necessary regulatory oversight to mitigate the adverse impact of financial failure or mismanagement of network assets. It also aligns new operators with the existing TOs and the transparency that will provide. The absence of a consistent approach may also be felt through inconsistencies in the quality of service experienced by end customers. All obligations must be considered including but not limited to the following:

- Provision of regulatory financial and cost information through the regulatory reporting framework;
- Compliance with Data Assurance obligations;
- Financial ring-fencing and indebtedness;
- Investment grade credit rating;
- Sufficiently independent non-executive directors;
- Compliance with relevant codes of conduct and practice; and
- Compliance with regulatory corporate governance.

The appetite for such obligations needs to be core to any regulatory framework and the 'watering down' of conditions is not appropriate given the potential scale and size of potential third party operators who in their own right will own critical UK infrastructure. The practical challenges (and costs to all parties) involved in incorporating enforcement against these obligations into a contract framework should not be underestimated. Similarly, the approach proposed by Ofgem may raise challenges for the system of Codes and Standards, which have been written for an environment where those responsible for operating network assets are regulated by Ofgem. Reviewing existing Codes and Standards for their applicability to this new model would be time consuming and not without cost to the industry. Ofgem will need to factor these costs into its RIA, as well as the (highly) likely costs of litigation around enforcement should the TO find itself having to enforce regulatory obligations through contract.

d. The identified benefits?

Competition has the potential to serve as a mechanism for soliciting novel solutions to challenges, but the proposed SPV model would appear to reduce significantly the potential of competition for delivering benefits to end customers. From a contracting perspective, the ideal approach would be for the TO to specify a detailed service within a contract against which to solicit bids. Drafting separate contracts for each of a potentially wide range of solutions is a costly and time consuming exercise, with the associated risk that some potential bidders feel excluded where the TO has not been able to foresee their specific proposal and incorporate it with sufficient detail in a draft contract. Under this scenario, it is not clear that the SPV model delivers benefits in addition to those associated with the existing TO-led model or potentially the competition proxy solution. We would expect Ofgem to publish a draft RIA for more detailed comment.

e. Any downsides or implementation risks?

There are generic challenges posed by a tender process. For instance, nothing is guaranteed to happen, with any bids ultimately subject to regulatory approval on licence requirements and cost recovery mechanisms meaning that negotiation will always require approval from Ofgem, so that recovery is certain. You can only pick from the tenders submitted and on the basis of the prices submitted – this is likely to include significantly more than a regulated margin.

9. What are your thoughts on the Competition Proxy model, including?

Our comments are general in nature and National Grid would be better placed to respond in relation to the Hinkley proposal. However, whilst we feel that the competition proxy model would represent a lower risk to end customers than the SPV model, there are a significant number of practical challenges which we believe Ofgem has not addressed in the consultation document.

a. The structure of the model and length of the revenue term?

We note that the proposed 25-year revenue recovery period against a 40-year asset life would give rise to a situation whereby Ofgem believes that the asset would have zero regulatory value, but the TO may yet have to fund the operation and maintenance of the asset for up to another 20 years. Ofgem have not made clear how this additional cost to the TO is to be funded. We do have concerns about how such a regime will work and believe that an expert industry working group must be set up to design and agree the detail of the regime. If a residual value is to be considered appropriate, then this should be equal to the net book value of the Regulatory Asset Value (RAV) of the investment as opposed to any proposed 'bid' residual value. This would ensure a consistent application of costs to consumers over the life of the asset in line with current RIIO arrangements.

In addition, we note that although an alternative approach, retaining a 40-year revenue recovery period is in line with the current RIIO framework for T1, the BGT appeal to the CMA and the subsequent final determination indicates that a review of the 40-year asset life come under review by Ofgem. In the event there is a revision to asset lives in advance of future price controls, there may be a need to revise the revenue recovery period to ensure the balance of charges is equitable between different generations of customers (thus ensuring intergenerational equity). We believe this uncertainty should be resolved prior to setting the financial parameters for cost recovery for the proposed extension of competition particularly given the intergenerational implications.

We believe that Ofgem needs to consider the cost to customers that may arise as a result of an 'aged' asset (being 25 years old) requiring refinancing by the TO and whether this may lead to increased financing costs and operational and maintenance costs. We believe Ofgem should undertake analysis on a range of potential 'feasible' options and consult in sufficient detail to inform a wider discussion; otherwise this may become an issue for future customers.

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

It is not clear why it would be beneficial for customers to start construction funding only when a project has been completed under the competition proxy model. The downside risk of releasing funding ahead of completion identified in the case of the proposed SPV model do not apply to the competition proxy model.

d. The identified benefits? & e. Any potential downsides or implementation risks?

We believe that the incentive mechanisms within the RIIO framework already ensure that customers benefit fairly from efficiencies delivered by the regulated network operators. As explained above, we already incorporate competitive methods in the appointment of contractors. Any benefits from the further extension of competition would need to be included within Ofgem's RIA as an increment to the efficiencies already delivered in the status quo approach. The lack of detail on Ofgem's proposal and the absence of experience of this model in practice means that identifying actual benefits or downsides for the inclusion in the RIA is challenging. There are obvious uncertainties around how Ofgem will estimate the return permitted. However, should Ofgem decide to pursue a non-legislative approach to the extension of competition the competition proxy model would be a lower risk step than the SPV model. Whilst Ofgem might favour the SPV model ultimately, it may be pragmatic to use the competition proxy model as an intermediate step, allowing the wider supply chain to adapt to the new environment and allow the industry and Ofgem to work together in parallel on solutions to the contractual and other challenges posed by the SPV model. It could be used as a 'test bed' which does not require a whole new set of rules which would otherwise be difficult to roll back if unsuccessful.