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Extending competition in electricity transmission: commercial and regulatory framework for the SPV Model

Dear Matthew,

National Grid continues to support Ofgem's intention to look for new ways to deliver consumer value. However, we hold serious concerns that the SPV model as proposed would not be beneficial for consumers, with significant work required to ensure a robust and deliverable model, and with material additional costs overlooked in Ofgem's Impact Assessment (IA).

1. Despite progress made since the previous documents published on a potential SPV model, the proposals are still insufficiently developed to be practically implemented, or for a solid understanding to be gained on the true costs and benefits involved in these very complex arrangements.
2. From what we do know of the model, the IA fails to include, or understates, a number of significant costs that consumers would bear (either directly or indirectly), and which would be likely to offset any benefits. These include:
 - understated cost of capital and other costs assumed for an SPV bid
 - a failure to include the cost to consumers of fairly compensating the host TO for increased risk it faces, including for sizeable licence breach financial penalties
 - a failure to consider the impact on TO financeability and credit metrics, and the costs associated with remediating this
 - a lack of consideration for potential wider costs to consumers, e.g. to reflect the increased risk of delay to delivery, costs in the event of the default of a highly geared SPV, or consumers potentially having to pay to replace assets sooner than under SWW
 - flawed reliance on low cost of debt to drive enduring value vs. the SWW counterfactual
3. The IA also fails to consider the cost to consumers of bringing forward a new model part way through a price control, which might be additional to the costs described above. The introduction of SPV is out of line with the RIIO-T1 Final Proposals, which set out two alternative models for delivering these types of projects: either Strategic Wider Works, at the RIIO-T1 Cost of Capital, or via a competitive process to appoint a new TO licensee with the full set of direct regulatory controls and safeguards. By introducing SPV during RIIO-T1, Ofgem may be creating regulatory uncertainty, impacting investor confidence, and potentially driving additional cost to the consumer.

4. Finally, by adopting a 'late model' and by considering the exclusion of legally separate TO affiliates from bidding, Ofgem is not consulting on an SPV model which would maximise the available consumer benefit.

Overall, while we recognise that progress has been made, the proposals are still not sufficiently developed to give confidence in the model's potential to drive consumer benefit. Little evidence has been given that significant concerns regarding the structure of the model can be overcome, while significant additional costs and risks have been ignored or under-represented. We strongly oppose the introduction of the SPV model as currently proposed.

Our concerns are laid out in more detail below.

1. *The proposals are still insufficiently developed to be practically implemented, or for a solid understanding to be gained on the true costs and benefits involved. For example:*

- **Tendering:** It is not clear how Ofgem would ensure that benefits from new entry overcome bidding costs, especially where several parties need to address complex tendering and project requirements. There may be an insufficient number of bidders to drive value, as some suppliers may be unwilling to participate in an aggregated model where they bear integration risk, and the pipeline of repeatable projects (as observed in the OFTO regime) may not be sufficient to attract bidders. More work would be required to develop the template contracts and clarify the potential impact of Ofgem's veto powers. Given volatility in external needs, the specific arrangements for contract updates and managing tender failures would need further consideration. Simply re-running the tender process, which would introduce further delay and cost to consumers, is an insufficient mitigation.
- **Operations:** Greater clarity is required regarding operational responsibility between the TO and SPV, including the distinction between "operational control" and "day-to-day O&M", which appears unclear in Ofgem's proposals. In order for the model not to drive inefficiencies and cost for the consumer, the scope of each party's activities, as well as how the interface would work, would need to be clearly defined. It is also unclear how the model would work if additional large scale works, such as asset relocation to facilitate third party works, were required during the operational period.
- **Quality standards:** Quality standards are essential to ensure the safe and secure operation of the National Electricity Transmission System. Further work is required to agree asset quality requirements from ongoing maintenance regimes and so protect value for end consumers and connecting customers in the longer term, given that the SPV would only be in place for 25 years. Under SWW, the TO is responsible for the assets for their entire lifecycle, and as such is incentivised to undertake thorough asset maintenance, and to operate the assets so as to prolong their useful life.
- **Risk sharing:** The contractual arrangements between TO and SPV, including the allocation of risk, will be key to the successful delivery of the SPV model, but are currently far from clear. If risks are not clearly allocated, they could be priced in by both parties, which would result in increased costs for consumers. Areas requiring clarity include:
 - How the Delivery Agreement could fully replicate the TO's licence obligations, especially as Ofgem can intervene and would have additional objectives (e.g. to reduce barriers to entry and encourage competition). There has been no consideration for mechanisms to compensate the TO for additional risks borne as a result of the SPV's activities: these risks include breaches of the host TO's licence obligations, HSE regulations, Development Consent Order and industry codes.
 - We expect that the host TO, as licensee, would continue to hold the Development Consent Order (DCO). As the TO retains the licence obligation to deliver the project, then we would not expect the benefits of the DCO to be transferred, as this is a lengthy and complex process

which has not been undertaken to date. However, this means that the host TO would continue to be liable for breaches of the DCO, and it is worth noting that DCO breach “without reasonable excuse” is a criminal offence. The IA does not envisage compensating the TO for this risk or any actions it may take to mitigate it.

- During construction, fully fixed-price construction contracts are unlikely to result in an efficient allocation of risks, as contractors may price risks at an inefficient level if they are not well placed to bear them. As such, there is additional detail required beyond that in the Agilia report on how associated risks are best shared between the SPV, the TO and consumers. There also needs to be clarity on how this affects any refinancing benefit sharing following a successful commissioning.
- In the case that an SPV defaults or fails to deliver, the SPV model makes provision for TO step-in. However, it is not clear who would meet the costs of the TO stepping in, in a situation where the SPV cannot meet these costs due to financial distress. The recent financial distress of Carillion demonstrates that this is not a purely theoretical concern. It has not been articulated whether, or how, financiers would still have rights to the revenue stream. It is also not clear who will compensate the SPV in the event of a no-fault termination or delay of the SPV contract.
- Finally, we note that while Ofgem cites ‘well tested and understood, financeable and value for money risk allocation positions’ and other ‘established principles’ on which the SPV model is based, the DPC regime in Water is yet to be tested in practice. In addition, the SPV model that Ofgem proposes has its own specific challenges. Ofgem needs to ensure transparency with wider stakeholders and consumers on the development of the model, to build confidence in the regime.

2. The Impact Assessment fails to include, or understates, a number of significant costs that consumers will bear, and which are likely to offset any benefit

- Ofgem understates the costs of capital, and other costs, in its assumptions on what a prospective SPV would offer:
 - Ofgem envisages a highly geared, Project Financed SPV with a low cost of capital. For the SPV to access a low cost of equity and make use of high gearing, there must be a substantial de-risking of the SPV element of the project. This de-risking, which would either result in increased risk for consumers or the host TO, or increased capital costs due to risk transfer to contractors, has not been factored into the Impact Assessment. Project Finance secured by SPVs may therefore be at higher cost than TO balance sheet financing for equivalent risks. Neither these increased costs nor the costs of setting up Project Finance have been factored into Ofgem’s Impact Assessment.
 - Moreover, the introduction of a new highly geared party introduces additional risk for delivery of consumer outputs, which has not been priced into the IA. Any benefits associated with taxation effects should not be included in the IA, as consumers are generally also taxpayers and would have to make additional tax payments elsewhere to avoid a shortfall.
 - Project Finance typically consists of a robust security package whereby lenders have the ability to seize the project’s assets or shares in the event of financial distress. Under the SPV model, it is not clear that the TO can meaningfully provide this security absent also transferring the license to lenders to be able to own and operate the assets. As the security package available to lenders would be weak, it is not clear that the project would be bankable. If lenders were willing to participate in the SPV model, they would factor the lack of security package into their expected returns, increasing the cost of financing the project beyond that assumed by Ofgem. Lenders would require a robust and complex set of commercial arrangements to give them comfort that they would be able to access the SPV’s revenue

- stream: the framework as developed would not be sufficient. Lenders would also need to be confident that the SPV's revenue stream is guaranteed, which is not the case here due to the potential for a change to the project need or timing during construction, or performance under the availability incentive. Additionally, lenders may be concerned that the SPV does not have full operational responsibility for the assets on which its revenue stream depends, and may place additional restrictions on how the assets can be used to help protect their investment.
- The eligible projects for the SPV model are more diverse than those tendered under the OFTO regime, particularly as construction forms part of the tender process. For bid costs to reduce over time, there would need to be a pipeline of similar projects to increase bidder interest in participating in the regime. Onshore projects are diverse and complex, and bidders would need to be comfortable with the risks associated with construction as well as the characteristics of a new regime. For this reason, benchmarks from the OFTO regime are not meaningful.
 - Ofgem fails to consider costs to fairly compensate the host TO for increased risks such as licence breach exposure:
 - While further clarity is required on risk allocation (described in Point 1 above), Ofgem's IA appears to assume that the host TO retains additional risks rather than pass these to the SPV (given the low cost of capital and other costs that they foresee from an SPV bid). However, Ofgem has failed to recognise the costs that would be incurred by the host TO in managing these risks, which include:
 - i. Increased exposure to licence breach: the host TO would retain the licence obligations associated with the project but have less control over delivery and performance than in the SWW counterfactual, as the provisions in the contract would not be expected to give the TO full control over SPV delivery. Although the TO outsources construction and some maintenance activities at present, the duration and scope proposed in the SPV model exceeds what is currently considered best-practice. As such, the host TO is likely to bear increased risk from any delivery delays, and SPV breaches of industry codes, Health and Safety legislation, and the Development Consent Order. *To note, we consider that the risks would best sit with the SPV as it is best placed to manage them. However, as mentioned in point 1, this is not the proposed model and, if it was, it would add cost to the SPV bid relative to Ofgem's current assumptions.*
 - ii. The host TO would also bear the risk of incomplete cost recovery as a result of running the tender process, and if there is a revenue adjusting event during construction or operation.
 - iii. At the end of the 25-year period, the host TO would bear the risk of taking over poor quality assets, which may have been constructed and maintained to lower standards than would otherwise be the case.
 - iv. Finally, as many stakeholders would not be aware of the existence of the SPV model, the host TO would face the reputational consequences of the SPV's actions.
 - Ofgem has not considered the credit implications for the host TO, and resulting cost to the consumer
 - According to the credit rating agencies' published rating methodologies, the SPV model would negatively impact the host TO's financeability and credit headroom. Under accounting rules (IFRS16) the TO would record the future payments due to the SPV as a lease (i.e. a balance sheet liability similar to a debt) but there would be no offsetting asset such as a TO RAV addition: there would therefore be debt with no corresponding RAV. If it is recognised as an asset in RAV, then the SPV would effectively be 100% geared. In order to maintain NGET's notional gearing level of 60% and associated investment grade credit rating, lower gearing would need to be used elsewhere in the portfolio.

- Ofgem has failed to consider or quantify several material wider costs, or risks, to consumers
 - **Longer lead times to delivery:** The SPV model envisages a linear process with multiple stage gates. For example, once the Final Needs Case is confirmed, a 12-15 month process would need to be run before any construction activity can take place. The market is not likely to engage until there is confirmation of the project need and delivery model, and potential SPVs may struggle to engage with subcontractors until they have been appointed as the successful bidder. In contrast, TOs often run processes in parallel to ensure that customer connection dates can be met. Introducing delays to large infrastructure projects would make visibility for customers on connection dates more challenging, potentially compromise connection dates for new low-carbon generation, and increase the likelihood of increased constraint costs, which would be borne by consumers. Ofgem has not quantified the impact of such delays.
 - **Wasted Tender Costs:** The Impact Assessment also does not take account of the wasted tender costs which would be incurred if the project need case disappears during the process. As the process of appointing an SPV may need to take place before conventional procurement would start under SWW, it may take place when the project need and timescales are less certain. TO tender costs and a proportion of bidder costs are still paid if a tender is cancelled: although not funding these costs would deter potential bidders and leave the TO with a funding gap. Funding them would increase consumer costs compared to the counterfactual.
 - **Risk of default:** The SPV high gearing assumptions, upon which Ofgem bases its consumer benefit, would increase the risk of SPV financial distress. In the event of an SPV default, consumers would bear additional costs associated with the TO stepping in, the re-running of the SPV tender process, and potentially additional constraint costs. However, Ofgem has not taken this into account in its IA.
 - **End of contract risk:** It is not clear how customer and consumer value from SPV-delivered assets is protected and realised out to the end of their asset lives (after 25 years when the SPV contract ends). Consumers (and/or the TO) may therefore be left with the additional cost and risk of replacing poor condition assets earlier than under SWW. This cost has not been factored into the IA.
 - **25 year payback:** Under the SPV model, consumers would pay back the cost of the assets over a shorter period than SWW. It is not clear that this is in consumers' interest, given consumers' preference to defer spending on investments where the project cost of capital is below the Government's Social Time Preference Rate.
 - **Tax implications:** The key realisable benefit of high gearing is reduced corporation tax, however this in itself comes at a cost to taxpayers, who are generally also consumers.
 - **Reliance on PFI:** Ofgem has largely based its SPV proposals on the Private Finance Initiative (PFI) model. This is despite the poor track record of PFI¹ in delivering consumer benefit, and the Government's decision in October 2018 to abolish the use of PFI for future building projects.²
- Finally, the reliance on low cost of debt to drive enduring value vs. the SWW counterfactual is flawed:
 - If the SPV model is to be used on an enduring basis, capturing today's low cost of debt will be at best a temporary benefit and not an enduring driver of value for consumers.

¹ <https://www.nao.org.uk/wp-content/uploads/2018/01/PFI-and-PF2.pdf>

² <https://commonslibrary.parliament.uk/parliament-and-elections/government/goodbye-pfi/>

- The iBoxx tracker takes account of the cost of debt over a period of time: if the SPV model were used for all projects meeting the competition criteria, and the same type of debt was being raised, then on average there would be no net reduction in the cost of debt compared to the RIIO model which also uses the iBoxx. However, SPV lenders would expect to use structured debt products, which are typically more expensive.
 - The Impact Assessment assumes that the SPV model should be compared against a version of the RIIO framework which uses the iBoxx 10-year trailing average cost of debt. However, the RIIO-2 proposals refer to the possibility of treating embedded and new debt separately. If this mechanism is to be introduced in RIIO-2, or in future RIIO price controls, then there would be negligible benefit associated with having locked in debt for 25 years under SPV.
- 3. The IA also fails to consider the cost to consumers of bringing forward a new model part way through a price control. The introduction of SPV during RIIO-T1 creates regulatory uncertainty as it is a development out of line with the Final Proposals.**
- RIIO-T1 Final Proposals envisaged either SWW or a competitive process to appoint a third party TO³. The introduction of a new model part way through the price control impacts investor confidence by increasing the regulatory that equity investors ultimately bear, and has the potential to raise cost of capital for RIIO-2 and beyond, creating further cost for consumers to bear.
- 4. Finally, by adopting a 'late model' and by considering the exclusion of legally separate TO affiliates from bidding, Ofgem is not consulting on an SPV model which would maximise the available consumer benefit.**
- Consumer value is most likely to be delivered by introducing competition at the very early stages of the development of a transmission project so that the full benefits from innovation in design solutions, risk management and delivery can be realised. As a 'late model', the proposed SPV model is not set up to capture all of these benefits. To ensure that the IA is robust, the degree of innovation and resulting benefit to consumers must be more realistically assessed.
 - One of the stated benefits of introducing onshore competition is to access new sources of labour and financing. To maximise these potential benefits, the scope of the competition should be as wide as possible. This means not excluding any suitable bidders, for example companies within the licensee's group which are already legally separate, and have clear physical and managerial separation. To exclude a bidder of this type would deny consumers the benefits of established supply chains and field force networks that are already established. Ofgem should clarify its policy on this as soon as possible.

Yours sincerely,

[By email]

Chris Bennett

Director, UK Regulation, National Grid

³ <https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf>

Responses to specific questions

Commercial framework

Question 1: What are your views on the commercial framework as set out in the accompanying Agilia report?

The commercial framework currently proposed for the SPV model is not workable. It sets out a model where, as we understand it, the TO would remain responsible for delivering network service outputs that are facilitated by the actions of the SPV, and the TO would remain the owner of any transmission assets developed. On this basis, the SPV model would represent a subcontracting of TO responsibilities (via the Delivery Agreement) to construct, finance and maintain transmission equipment to meet TO outputs. This raises a number of issues:

- As the TO would have a clear obligation to make payments to the SPV over a 25-year term for the construction and maintenance of the TO's assets, the accounting treatment under IFRS16 would be expected to reflect the presence of this outsourcing liability in full on the TO's balance sheet. The statement of this full liability without a corresponding regulatory commitment (e.g. via RAV) could impact the TO's ability to meet the licence obligation concerning credit rating: this is not currently considered in the IA. As a minimum, the approach to this issue by credit rating agencies should be explored, as well as the potential for any compensating actions.
- Although the Delivery Agreement (DA) would aim to specify the SPV activities that support TO responsibilities, inevitably it would not completely cover them, and as such the SPV would only take on a subset of the relevant TO responsibilities. The materiality of liabilities remaining with the TO should be identified, and the TO would need to be funded for these liabilities. Any situations where the allocation of risk is not clear would result in risks being priced in by both parties: a comprehensive DA would therefore be essential, to ensure that consumers do not face additional cost. The IA does not currently envisage any funding to compensate the TO for its liabilities, and therefore would need to be revisited. Prior to the development of a full DA, the following areas need to be considered:
 - Ofgem would have additional objectives for the DA and the associated tender arrangements beyond those that a TO would consider when outsourcing activities under its current business model. For example, it is likely that Ofgem would seek to reduce barriers to participation. It would be necessary for Ofgem to clarify the interaction between its objectives and those of the TO, as in many situations the TO would need to take a risk-averse approach to outsourcing in order to reduce its risk.
 - Given that implicit liabilities on the TO would depend on the DA Guidance and project-specific DA drafting decisions by Ofgem (both of which would sit outside of the licence), any appeal of licence modifications would not provide effective recourse for the TO. Ofgem would need to clarify the scope of its role, and the options for TOs to dispute any decisions taken.
 - It would be necessary for Ofgem to clarify the extent to which it could take retrospective action in relation to tendering or contracting outcomes that it might consider were not properly addressed by the TO in the drafting of the DA, or in the conduct of the tendering process.
 - As the SPV model would require a different form of contracting to that which is currently used for TO construction projects, there could be significant cost and time associated with setting up new forms of contract. These costs could include revised requirements for fixed price construction contracts, and new bid bond requirements. This would need to be factored into Ofgem's estimate of the costs and timescales associated with using the SPV model for the first time.
 - In order to ensure that the introduction of a new regulatory model does not result in a deterioration of standards across the industry, the TO should be able to impose strict

requirements on the SPV in terms of health, safety and environmental standards and track record.

- The arrangements for TO step-in need to be clarified. The provision for TO step-in in the event of SPV default or contract breach makes it clear that the TO would retain significant obligations associated with the SPV. However, it is not clear who would meet the costs of the TO stepping in, in a situation where the SPV could meet these costs itself due to financial distress. It is also not clear who would compensate the SPV in the event of a no-fault termination of the SPV contract. We would also anticipate that the SPV model would introduce a cross-default obligation, as the TO would be impacted if the SPV defaulted. This is a further indication of the risk which the TO would bear, and Ofgem would need to clarify whether it would be covered by existing consents.
- The proposed Direct Agreement between the TO and the SPV's financiers would impose an additional liability on the TO. The form of this contract would require significant further development to ensure that it is workable for the TO, as well as giving sufficient confidence to lenders.
- It is not clear to what extent the SPV would be able to access a low cost of capital, as the proposed commercial framework does not comprise of the security package and guaranteed revenues which would be expected in a typical Project Finance deal. This is described in further detail in the executive summary, and needs to be taken into account when assessing the likely consumer benefit of the SPV model.

Other issues which would benefit from further assessment include:

- The consequences of the anticipated high SPV gearing on financial robustness. There would be risks to customers from delays caused by financial distress of an SPV, and potential step-in liabilities for TOs which have not been priced into the current IA. An SPV promising a low cost of capital may not have factored in the full extent of risk which it is expected to bear. As such, the TO should be able to set requirements on the SPV's financial arrangements when specifying the terms of the tender process. We would also expect the DA to mitigate the risk associated with SPV default, either by specifying requirements such as an investment grade credit rating or by requiring the SPV to hold a bid bond. The long-term interest of consumers is best served by the construction of high-quality assets by companies with sustainable financial models.
- The premia that would be required to fix costs by way of an EPC wrap, and the mitigating effects of permitted reopeners.
- The extent to which bidders would factor the requirement to share future refinancing benefits with consumers into their bid costs, given that the prospects for refinancing will not be known until some time after contracting. Re-financing in order to extract value between construction and operation is a key source of upside for investors, and the obligation to share this benefit is likely to result in higher tendered costs.
- The effects on SPV revenues if construction or commissioning is delayed due to unexpected retiming of user needs (e.g. SO recommendations from the NOA), and the extent to which bidders would factor this uncertainty into their tendered costs.

The 25-year duration of the Delivery Agreement, and full depreciation of the assets over this period, raise questions about the responsibility for ensuring that the assets are able to provide value to customers over the remainder of their potentially longer physical lives. As this is a material issue for many categories of transmission equipment, the impact on the overall cost-benefit for the regime should consider the risk of potentially shorter physical equipment lives, and the costs associated with early asset replacement or additional maintenance after the end of the revenue term.

- In order to minimise the risk of difficult to rectify asset degradation and ensure ongoing system operability and resilience, the TO would need to set strict requirements on the SPV's equipment

design and maintenance policy. It is therefore difficult to envisage significant cost savings resulting from innovation in asset design and maintenance.

- It is not clear what liability SPVs should face for unexpected asset degradation towards the end of the contract. It could be expensive for SPVs to raise new finance for rehabilitation actions, and the requirement for the SPV to maintain a financial facility for such eventualities could further impact on the consumer case for the model.

Other customer impacts, such as the potential for time delays resulting from the SPV appointment and DA agreement process, should be represented in the IA. The SPV model envisages a single contract being awarded to the SPV, which would then need to award various sub-contracts: this introduces a sequential process. The current method of TO contracting allows for different contracts to be tendered and awarded separately, allowing contractors to begin work on one element of the project while a tender is still underway for another part of it. It is therefore expected that the SPV model would result in increased timescales for procurement, which would not be in the consumer interest, due to increased constraint costs and delays to the connection of new low-carbon generation.

Question 2: Do you agree with the scope of our role in the SPV model?

Whilst we understand why Ofgem needs to consider the scope of its role, this question highlights the complexity of the SPV model and the interactions between different parties. The SPV model would introduce an additional interface between the regulator and the party responsible for asset delivery. This would lead to additional cost and complexity compared to the counterfactual of delivery by a regulated TO, and reduce the extent of regulation of critical national infrastructure assets.

A licence-based model would be superior, enabling the licensee to have compulsory powers, clear accountabilities, and direct regulatory oversight. It would allow Ofgem to impose any enforcement actions directly on the party which has caused the licence breach, rather than introducing an additional risk to the incumbent TO.

We note that the Delivery Agreement and associated guidance would not limit the interventions that Ofgem might make to the DA and tendering arrangements. The absence of a link between TO revenues and the payments the TO would need to make to the SPV under the DA, and the limited precedent for mandated outsourcing arrangements, mean that TOs would face significant regulatory risk from the SPV model.

We assume that Ofgem would provide or extend TO consents in respect of incurring a cross-default when subcontracting to an SPV.

Question 3: Do you agree with the scope of the Independent Technical Advisor? Do you have examples you can share of Independent Technical Advisors working well or not so well, and any examples of lessons learned from this approach?

If the ITA is to play a trusted role, its opinion on whether additional costs associated with unforeseen events have been efficiently incurred should be sufficient for Ofgem to agree to fund the TO these additional costs. The current proposal is illogical, and would introduce unnecessary risk for the TO. It is unclear why the decisions made in relation to the licence and Delivery Agreement could not be aligned.

The introduction of an ITA introduces additional complexity compared to the CATO model, which would have allowed for direct regulation by Ofgem.

Question 4: What are your views on operational period incentives for the SPV?

It would be logical to give the SPV its own separate incentives which were ring-fenced from those of the TO. However, this may be difficult to achieve in practice, given that SPV assets would form part of a meshed network and would be subject to the same operational control as TO assets.

Any incentive framework developed for the SPV would need to incentivise responsible asset management, in order to counteract the behaviour which could result from a contract duration which is shorter than the asset's physical life.

If an incentive scheme had been agreed upfront with Ofgem, then we would expect any incentive payments due to the SPV to be fully recoverable through the TO's licence. It may be necessary for the ITA to verify incentive performance in order to award payments to the SPV, to ensure that the SPV has earned additional funding from consumers.

Question 5: What are your views on where there may be consumer value in a target cost rather than fixed price model?

NGET's current procurement approach fixes costs where efficient, and allocates risks to contractors where contractors are best placed to bear specific risks. The introduction of an SPV model would remove this flexibility. A target price may offer greater value than a fixed price model in circumstances where the scope is not yet well defined (allowing contractors to drive efficiencies in design and scope). This is unlikely to be the case for projects where the scope is already well defined (e.g. by the requirements of the DCO planning process), where the opportunity to outperform the target would be limited.

A target cost model may also offer value where there is concern from the market that the total risk burden would not be tolerable, but it is important to note that in such circumstances some risk would need to be borne by the TO, for which funding would be required, or by consumers.

For a fixed price model to work, the SPV would have to de-risk the project by transferring risks to other parties. However, it is important to note that this transfer of risk would be expected to increase capital costs for the project.

Therefore, a target cost model would introduce a role for the TO in paying additional revenues to the SPV, and the lack of automatic adjustment to the TO's revenue to compensate for this would introduce additional regulatory risk for the TO. If a target cost model were to be used, NGET would need to be adequately compensated for retaining the residual risk implied.

Question 6: What are your views on possible TO and SPV enhanced alignment options?

TO equity stake in the SPV

Given the TO would be responsible for delivery of the outputs facilitated by the SPV, with any costs already subject to the RIIO totex incentive, a TO equity exposure to SPV performance is unlikely to bring material improvements in alignment or additional benefits for consumers. Rather, we are concerned that an obligation to take an equity share in the winning bidder would increase concerns regarding the potential for a conflict of interest during the development of the DA and the tendering process. This would be unhelpful in establishing an effective SPV regime.

An obligation to invest shareholder funds irrespective of the merits of the specific SPV would not be consistent with our duties to our shareholders.

Alliance Agreement

An approach which shares in the customer benefits of establishing a beneficial SPV would, in theory, be better than the equity share option. We appreciate that establishing suitable KPIs and targets is likely to be complex. However, these arrangements cannot be developed until the basic contractual framework has been established: this is clearly not yet the case.

Question 7: Are there any other points we should consider within the commercial framework?

It is not clear that it would be in the consumer interest for an SPV tender to be re-run if it is unsuccessful. For a tender to be run, Ofgem would have consulted on whether the SPV model is appropriate for the project in question. This should give Ofgem an indication as to whether there is sufficient bidder interest in an SPV model. Further, ahead of running the tender process, Ofgem would have approved the tender

documentation, giving it comfort that the terms of the Delivery Agreement would be attractive to bidders. The TO would have engaged with interested parties ahead of running the tender process. If no bidders subsequently came forward, this would indicate either unfavourable market conditions or an unsuitable regulatory model for the project in question: neither of these aspects would be resolved by re-running the tender process. Re-running the tender would not only cost money, but it would introduce a delay into the project timelines, which would result in increased constraint costs and delayed customer connection dates. If no suitable bidders come forward, we would suggest that Ofgem revert to the established Strategic Wider Works model, noting that incumbents would still need time to undertake procurement, and re-running the SPV tender process would compress the timescales for this procurement process.

It is important to note that the SPV's scope for innovation in design and delivery will be limited by the consents which would have already been obtained by the host TO. We would recommend that Ofgem focuses on developing a licence-based model, which would facilitate an early model where the benefits of competition can be truly realised. Under the SPV model, as the SPV would not hold a licence it would not have the same statutory powers as licensees, making an early model harder to implement.

Another issue not explicitly addressed in the consultation document (but potentially relevant to the choice of the proposed form of the SPV model) is that, without transmission asset ownership, the consultation appears to assume that participants in an SPV would not be subject to the transmission licence and associated unbundling and certification requirements applying to a licensed TO under the Electricity Act. It is for consideration whether SPV parties should be outside the definition of "participating in transmission" as defined in the Electricity Act, and consequently outside of the requirement to hold a transmission licence and to be certified as independent.

Regulatory framework

Question 1: What are your views on the regulatory framework as set out in this consultation, and how it interacts with the commercial framework?

The commercial framework is very complex and incomplete, and relies on a regulatory compulsion for licensed TOs to outsource a licenced activity in a manner which would currently be inconsistent with other regulatory incentives.

Choice of regulatory model

- It is important that Ofgem retains the existing Strategic Wider Works model as an option for large transmission projects. This would offer an alternative in the event that the SPV model is not workable, does not deliver a consumer benefit, or does not attract sufficient bidder interest.
- Meeting the Competition Criteria is necessary but not sufficient for a project to be a good candidate for the SPV model. Ofgem should also take into account deliverability, as well as project characteristics such as certainty of need, operational criticality and interactions with the rest of the network. Many such characteristics are set out in the water companies' PR19 business plans.

Impact on the TO

- The proposed arrangements would introduce new risk to the TO. They envisage a balance of risk and reward which may not be acceptable to a commercial company, noting that the TO would not have the choice as to whether to participate in the SPV model. These risks could include financeability, licence breach, DCO breach, breach of industry codes, breach of health, safety or environmental obligations, and incomplete cost recovery in relation to the tender process and any re-openers. There does not appear to be a mechanism to remunerate the TO for this additional risk: Ofgem simply proposes that the TO may (at best) recover its costs and has the opportunity to earn an incentive payment.

- It may not be possible to achieve complete alignment between SPV-TO and TO-Ofgem provisions, as the Delivery Agreement would not fully replicate the TO's licence obligations, and any mismatch would represent a risk which sits with the TO. This could materialise in an event of licence breach, where the TO could incur a significant fine which could not be passed onto the SPV by way of its Delivery Agreement. Similarly for Health and Safety arrangements, if the TO retains the role of the employer, it would bear the consequences of any breach by the SPV. There would need to be a suitable mechanism to mitigate this issue.
- The risk of licence breach may be more significant under the SPV model than under the counterfactual regulatory arrangements. This is because the SPV would operate and maintain the assets for a 25-year period, and may seek to construct and maintain the assets to a lower standard as a result of its lower allowances. Further, it is not yet clear what activities are included in the scope of "operate", and whether such activities would require the SPV to hold its own transmission licence.
- For Cost and Output Adjusting Events, it does not seem logical for Ofgem to disallow the TO funding for costs incurred by the SPV which the ITA has considered to be reasonable under the Delivery Agreement.
- For the SPV model to be workable, Ofgem would need to compensate the TO for the impact on its risk profile and credit metrics.
- We expect that the TO's role in managing the SPV would be extensive. The TO would retain the risk of breaching its licence or the conditions of the DCO, and as such would need to undertake extensive liaison, monitoring and co-ordination to ensure that the SPV's conduct does not negatively impact on the TO. An additional opex allowance would be required to fund the TO for these activities.
- Further engagement with credit rating agencies would be required to understand the full impact of the SPV model on the TO's metrics, whether it would be possible to mitigate this impact, and the cost of such mitigating actions.
- The consultation states that the mechanism for TO cost recovery would not be implemented until RIIO-T2. It would not be acceptable for TOs to incur costs in relation to the SPV model without clarity as to how these costs would be recovered.

Requirements under the Electricity Act

- Ofgem should consider further whether the SPV requires a transmission licence. Section 4 (1)(b) of the Electricity Act requires a person who "participates in the transmission of electricity" to be authorised to do so by a licence. S4 (3A)(b) refers to one activity, which requires a transmission licence, as that of making available for use for the purposes of such a transmission system referred to in (3A)(a) anything which forms part of it. S4(3B) then clarifies that a person shall not be regarded as making something available for such purposes just because he consents to it being made available by another. This implies that the TO's role in the SPV model would not be that of participating in the transmission of electricity, but contracting with the SPV for the SPV to do so, implying that the SPV would need a transmission licence. Ofgem has not addressed this issue (and the associated ownership unbundling requirements) in relation to the SPV entity.

Overall regulatory framework

- The introduction of the SPV model would gradually change the overall regulatory framework to introduce more regulatory deals which are fixed for 25-year periods, which are exempt from the regular price control process. As they would not be reset by regular price controls, these regulatory deals would effectively have priority in payment from the SO, and would not face stranding risk from future reductions in the consumer base. This would mean that cost pressures and ultimately stranding risk would be focussed on those which have regular price controls, and

could increase the risk on TO equity. If TO investors price in this risk, it could eventually result in increased costs to consumers.

- The fact that no changes would be required to industry codes highlights the fact the TO bears the responsibility for the SPV's compliance with industry codes. The fact that the TO would be accountable for delivery means that SPV would not be a true third party delivery model.

Licence Drafting

- Please see the table we have included as an appendix in which we set out initial comments on the proposed illustrative licence drafting.

Question 2: Do you agree with the scope of TO obligations during the pre-tender, tender, construction period, and operational period?

Pre-tender period

- TO activities in the pre-tender period would be largely the same as those currently conducted under the SWW process. Funding allowances for this work would need to be sufficient because, unlike under SWW, there would not be opportunities for uncertainties in the efficient costs for each development stage to average out over the full development.
- The TO is well placed to obtain planning consents and manage external interfaces, using its existing relationships and statutory powers. The Major Planning Consents, 3rd Party Agreements and Land Rights would need to be agreed before the SPV tender process can begin: this would need to be taken into account when assessing the impact of the SPV model on project timescales.
- Although the consultation states that it should be possible for TOs to run the SPV tender in line with required timescales and notes that TOs already include an allocation of time for procurement activities, we note that there would be less opportunity for the parallel working between design, obtaining major and secondary consents and procurement which currently takes place under the SWW approach. As such, the SPV model would be expected to result in a longer period of activity before construction can begin, compared to the SWW model.

Tender

- As stated in question 7 in relation to the commercial framework, it is not clear that it would be in consumers' interests to re-run the SPV tender if it failed due to no suitable bidders coming forward.
- The proposed extent of TO reporting to Ofgem seems reasonable. We would encourage Ofgem to flag any concerns with the process or choice of bidder as early as possible, as this would avoid unexpected disallowances of costs later in the process.

Construction period

- It would be logical for the TO as licensee and asset owner to retain responsibility for obtaining major planning consents, land rights and managing the discharge of any conditions or requirements (monitoring the compliance with existing consents) and external interfaces once the SPV is appointed, noting that the TO would need to be funded for this activity. This would allow TOs to deliver on the promises they have made to stakeholders during the consenting process, and allow TOs to manage their own reputational risk. However, it is important to note that the TO would still bear reputational and financial risk if the SPV does not fulfil the conditions of the consent: this is yet another risk which the TO would bear if the SPV model were introduced.
- Although it may be possible for the benefit of the DCO provisions to be transferred to another party, or granted to another party for a period of time, this would be a lengthy and complex process which has not been undertaken to date, and would require approval from the Secretary

of State. There is currently no stipulated process for transferring the benefits of a DCO, and it could take a number of years to enact. As such, we expect that the TO would retain responsibility for major consents.

- The TO would undertake the role of employer or client, and would oversee construction activities and compliance with planning consents. The TO would need to be satisfied that the project meets the output specification before it can be commissioned. There would need to be an escalation route if the SPV does not deliver on its commitments.

Operation period

- We would like to clarify the difference between “operational control” and “day-to-day O&M”, and the licence and associated requirements of each. Assuming that operational control refers to the operation of a TO control room, it would be logical for the TO, as licensee, to continue to undertake this activity. Where day-to-day O&M refers to field-based activities, it is not clear how the SPV could provide this service at a more efficient cost than incumbent TOs, given TOs’ existing pool of staff and strategic spares. The scope of each party’s activities, as well as how the interface would work, would need to be clarified, and working arrangements efficiently agreed.
- The Agilia report identifies that it might be beneficial for customers if highly specialised, expensive or long lead-time spares are provided by a sharing arrangement with the TO “providing that suitable terms in relation to access and cost can be agreed”. However, neither the Agilia report nor the consultation identifies the practical arrangements for reaching such agreements. We do not think it would be feasible or appropriate in competition terms for TOs to provide a standard menu of costs for such services during the tender process, but it would also be difficult to make bespoke bilateral agreements prior to SPV being established.

Question 3: Do you agree with our approach to structuring the TO’s allowances, including both base revenue and cost adjustments?

- It is not clear in the proposed licence drafting how the TO would be remunerated for its role in any part of the process.
- As stated in the executive summary, the TO would bear significant risk as a result of the SPV’s activities. The TO would need to be remunerated for this risk, as well as any implications in terms of additional monitoring, and measures would need to be taken to mitigate the impact on the TO’s credit metrics.
- It is not clear that it would be in the long term consumer interest for TOs to incur costs during the RIIO-T1 period, but have to wait until RIIO-T2 for the existence of a mechanism by which to recover these costs. If such a mechanism cannot be introduced in RIIO-T1, then Ofgem should wait until RIIO-T2 to implement the SPV model.
- It would reduce complexity to use the same form of indexation for the main RIIO price control and the SPV’s revenue stream.

Question 4: Do you agree with our proposed approach to operational period incentives, including interactions with the TO’s price control incentives?

To avoid penalising or rewarding parties who have not caused or contributed to an outcome, it would be desirable to provide separate incentives for the SPV which are ring-fenced from those of the TO. However, this may be difficult to achieve in practice, given that SPV assets would form part of a meshed network and would contribute to several of the current RIIO TO performance measurements.

If an incentive scheme had been agreed upfront with Ofgem, then we would expect any incentive payments due to the SPV to be fully recoverable through the TO’s licence. It may be necessary for the ITA to verify incentive performance in order to award payments to the SPV, to ensure that the SPV had earned additional funding from consumers.

It would be preferable to have a consistent incentive framework across the industry, rather than a set of bespoke incentives for each new asset.

Question 5: What are your views on our proposed arrangements for the period after the end of the SPV's revenue term?

The arrangements should ensure that the health of the asset at the end of the SPV contract would mean that it is fit to deliver benefits to customers for the remainder of its expected physical life.

The handback conditions within the Delivery Agreement would need to clearly specify the required asset condition. The ITA should then verify that the assets are in a suitable condition before the TO takes over operations and maintenance activities. Any unexpected costs which the TO incurs in relation to these assets after handback should be covered by a performance bond from the SPV, or passed through to consumers.

Question 6: What are your views on our conflict mitigation proposals? - Would the TO conflict mitigations proposed sufficiently mitigate conflict where a TO bidder seeks to participate in an SPV tender in its own geographical area? - And if not, what different/additional arrangements would be needed?

- In our view, the TO conflict mitigations proposed would allow for a fair competition to be run where a bidder within the TO's group seeks to participate in a tender in the TO's geographical area. Our experience and track record of operating with information ring-fences leads us to the view that the proposed TO conflict mitigations would be effective and so should permit a legally separate TO bid team to participate in the tender, enhancing competition by including an experienced and competent service provider.
- Given our proven track record, there would be no justification for excluding a "TO bidder" which is legally separate from the team running the tender. To do so would be anticompetitive and would exclude a well-qualified bidder from the competition.
- We would expect the tender team assessing the bids to follow strict rules which would forbid them from sharing any information obtained as a result of running the tender process with other parts of the TO. There are licence precedents for effective implementation of such information ring fencing. The TO SPV tender monitoring team would carefully manage any information received in relation to SPV costs, not sharing these with the rest of the TO. We would therefore expect the Project Development Team not to be able to access any information relating to bidders' costs.
- We would like to clarify whether the "separate physical location" referred to in table 7 means a separate room, or a separate building.
- It is worth noting that the requirement for business separation provisions would be extensive in a situation where a TO is running tenders for multiple projects at the same time.
- The employee transfer provisions would restrict the transfer of employees from the TO bidder to the TO until the tender process is complete. It is clear why employees from the TO bidder cannot transfer to the tender team, tender monitoring team or project development team, but it seems unduly restrictive to not allow them to undertake an unrelated job within another part of the TO.
- We note that the proposed business separation provisions are not yet included in the proposed licence drafting.

Question 7: Do you think that any changes to industry codes or standards are needed, or would be beneficial, for the SPV model?

The fact that no changes would be required to industry codes highlights the fact the TO would bear the responsibility for the SPV's compliance with industry codes. The fact that the TO would be accountable for

delivery means that SPV would not be a true third party delivery model, and the TO would need to be funded for the risk that it bears.

Procurement principles

Question 1: Do you agree with our proposed procurement principles?

- Without offsetting in any way our wider concerns about the benefits to consumers of this regime, we think the proposed procurement principles are generally sensible.
- We agree that the TO should be responsible for designing, running and concluding the tender, as the ongoing accountability for the SPV's activities would remain with the TO. We do not envisage that any benefits would result from a third party running the SPV tender.
- In order to mitigate the risk associated with SPV asset failure, the TO would need to stipulate, as part of the tender process, stringent specifications in relation to asset quality and maintenance. These could include following the same design and maintenance specifications currently used by the TO, and having a strong record of high performance in relation to health, safety and the environment.
- The Delivery Agreement would also need to include measures to control default risk. For example, the SPV could be required to hold an investment grade credit rating, and/or bid bonds to provide reassurance that it could cover its costs. The costs of these measures would need to be reflected in the Impact Assessment.
- The proposed tender duration of 12-15 months would vary depending on the nature of the project. Note that, once an SPV is appointed, the SPV may subsequently need to appoint sub-contractors to undertake different elements of the project. Although the SPV could have engaged with subcontractors ahead of bidding for the project, it is unlikely that these arrangements could be finalised before the SPV has won the contract.
- NGET already engages with a significant proportion of the available supply base. It is unlikely that there would be a significant number of additional suppliers who are willing to undertake work of this type. For some asset types, there is a limited pool of companies which could deliver the project, and therefore the introduction of the SPV model would not be expected to introduce new players to the market.

Question 2: Are there any other areas where we should be setting firm requirements regarding procurement of the SPV, or where additional guidance would be helpful?

It would be useful for Ofgem to clarify the extent to which the TO could use the procurement process to set requirements on the SPV to reduce the TO's risk, for example in relation to financial security and asset specifications.

Question 3: Are there any areas included in this chapter where we should not be setting requirements regarding procurement of the SPV?

Ofgem states that the TO should ensure that the questions and evaluation strategy do not advantage one form of financing over another. In our view, as the TO would be expected to step in if the SPV defaults, it would be necessary for the TO to mitigate the risk of SPV default, for example by restricting the SPV's financial structure or requiring it to hold a performance bond.

Impact Assessment (IA)

Despite progress made since the previous documents published on a potential SPV model, we note that Ofgem's SPV proposals are not yet sufficiently well developed to allow for a robust assessment of consumer benefit.

However, the published Impact Assessment either fails to include, or understates, a number of significant costs which would result from the implementation of the SPV model. It also does not take into account the cost to consumers of bringing forward a new model part way through a price control. Finally, by adopting a 'late model' and by considering the exclusion of legally separate TO affiliates from bidding, Ofgem is not consulting on an SPV model which would maximise the available consumer benefit.

(i) Ofgem understates the cost of capital and other costs assumed for an SPV bid:

Ofgem's IA significantly underestimates the cost of capital and other costs which would be bid by SPVs.

- OFTO data:
 - Ofgem cannot assume that the low cost of capital it has observed in OFTO auctions would be applicable to onshore transmission projects. The SPV model differs considerably from the OFTO model, as OFTOs operate under a transmission licence (awarded by competitive tender) on an enduring basis which clearly specifies their relationship with Ofgem.
 - Ofgem draws on its experience of the OFTO regime to estimate TO and bidder tender costs. However, the OFTO procurement process is mature, and there is a pipeline of similar projects which do not bear construction risk. The SPV model is new, and would encompass a diverse portfolio of assets. As the SPV would be required to undertake construction, the choice of preferred bidder would have to take into account a wider range of aspects. We would therefore expect to see higher tender costs for both bidders and TOs under the SPV model.
- Debt:
 - Ofgem refers to the ability to lock in the historically low cost of debt currently available in the market. If SPV is designed to be an enduring model, it cannot be assumed that all SPV projects will begin at a time when the cost of debt is at a historic low.
 - The Impact Assessment assumes that the RIIO cost of debt is set using the existing RIIO-T1 methodology. However, if future RIIO controls differentiate between new and embedded debt, then there would be negligible benefit in having incurred extra transaction costs to capture the cost of debt at the start of the project.
 - It is not clear how the SPV's lenders would access its revenue stream in the event of SPV default, as unlike under the PFI model lenders could not invite another party to step in to operate the assets. This would mean that lenders would require the value of the revenue stream to be more certain, which may not be the case due to the presence of an availability incentive. This could increase the required cost of debt.
 - The potential for project delay or cancellation, which could compromise the revenue stream, may also increase financing costs.
- Equity:
 - If an SPV could achieve a lower cost of equity than the counterfactual of TO delivery under SWW, then this must be due to a transfer of risk. If the risk were transferred to contractors, this would result in higher capex and opex costs: this link has not been explicitly recognised. There is no recognition of a transfer of risk to consumers, although consumers may well face additional costs in the event of SPV default. It would seem that significant risk remains with the host TO, and this is neither recognised nor compensated in the IA.

- Gearing:
 - The low cost of capital assumed by Ofgem is driven by the increased debt portion in the SPV's capital structure which replaces the typically more expensive equity. In this sense, the lower cost of capital is heavily driven by the use of a highly geared structure.
 - Higher gearing is associated with an increased risk of financial distress. This would increase the likelihood that an SPV would default, the TO would need to step in, and the process of appointing an SPV would need to be re-run: increasing risk and cost for both consumers and host TOs.
 - Higher gearing results in lower tax payments. Although this may make the project appear cheaper, those tax payments would have to be made elsewhere, offsetting the apparent consumer savings.

The underestimated cost of capital does not take into account how lenders are likely to perceive the model.

- Project Finance generally relies on the existence of a robust security package, whereby lenders can typically take over the project's assets or shares. This would not be the case here, as it is not clear that the TO could meaningfully provide this security absent also transferring the license to lenders to be able to own and operate the assets. If the project is to be bankable in the absence of a strong security package, lenders may require higher returns than under conventional Project Finance arrangements.
- For lenders to be comfortable with the arrangements, a robust contractual framework would be required, detailing the precise arrangements for step-in and termination: this framework would require significant further development. Further, it is not clear that the revenue stream would be sufficiently guaranteed or certain to give comfort to lenders, given the potential for a change in start date (if the need for the project changes), the presence of an availability incentive, and the SPV's lack of operational control of the assets upon which the revenue stream depends. The SPV model therefore differs from OFTOs and PFIs, where lenders would be able to appoint a new operator and continue to receive their revenue stream.
- Ofgem has assumed that SPVs will bid in low capital costs and rates of return but be willing to take on significant risk. If this is not the case, the consumer benefit will not materialise: we would be interested in whether Ofgem has approached parties who would be willing to invest in the proposed model at the quoted cost of capital, and whether the security package and certainty of revenue stream have been understood during those discussions.

The Impact Assessment also overestimates the capex and opex benefits which would result from the introduction of the SPV model, particularly in the scenario where lower financing costs have been achieved.

- Capex:
 - Capex savings are assumed to result from competitive pressures, innovation, and holistic end-to-end procurement.
 - TOs would be likely to seek to set stringent requirements as part of the procurement process in order to reduce their risk of licence breach associated with the SPV's activities. These requirements could include compliance with existing TO standards, for example in relation to safety, environmental performance and equipment specifications. These requirements, in addition to the fact that the TO would already have obtained planning consent, would reduce the scope for innovation.
 - If Project Finance is to be used to achieve high gearing and therefore a lower WACC, then it is expected that the associated transfer of risk would result in increased capital costs.

- As such, an assumption that 10% capex savings could be achieved is overly ambitious.
- Opex:
 - Opex costs are generally not material compared to overall project costs: Ofgem assumes 0.1% of project capex in the IA. Any savings here would therefore not make a significant difference to the lifetime project cost.
 - The Impact Assessment is overly reliant on savings from the OFTO regime, which could be due to other effects such as wind farm operators maintaining the OFTO assets at low cost.
 - Reduced opex allowances may lead to insufficient maintenance taking place, which could result in asset failure and increased costs in future years.
 - The estimate of opex costs does not include an allowance for the TO for the extensive activities it would need to undertake to mitigate the risk of the SPV breaching its licence. These activities would include extensive liaison, monitoring and co-ordination between the TO and SPV.

Ofgem also overestimates the impact of several other effects which would result from the introduction of competition:

- It is possible that competitive pressures in the supply chain could lead to lower costs. However, incumbent TOs already submit a large proportion of their activities to competitive tender: it is not clear that any additional market participants would participate in the SPV model, given the greater extent of activities required and the enduring nature of the obligation. It is difficult to robustly quantify this benefit, and we note that Ofgem's impact assessment considers both an increase and reduction in costs.
- Ofgem assumes that lower costs will result from holistic end-to-end procurement. However, TOs are currently able to benefit from economies of scale, and existing specifications take into account the requirement to operate and maintain the assets. It is possible that new entrants may bring new ideas, however the scope for innovation may be limited as the incumbent TO would have already obtained planning consent. It is difficult to robustly quantify this benefit.
- We recognise that a benefit of competition is the creation of new benchmarks which can be used in price controls. However, for these benchmarks to be relevant it would be important to take account of the difference in risk borne by TOs and SPVs. It is difficult to robustly quantify this benefit.

(ii) Ofgem fails to include the cost to consumers of fairly compensating the host TO for increased risk it faces, including for sizeable licence breach penalties:

Although the risk allocation arrangements between the host TO and the SPV are not yet clearly set out, as the IA assumes that the SPV can access a low cost of capital and low project costs, it would seem that the host TO retains a large proportion of the risks associated with the project. However, Ofgem has not recognised the costs to the host TO of managing these risks. These costs include:

- Breach of licence and associated penalties, as the host TO retains the licence obligation to deliver the project but does not have full control over SPV delivery and performance. The extent of outsourcing in the SPV proposals is far greater than that which TOs currently use, given the 25-year duration of the contract and handover of operational and maintenance responsibilities.
- Breaches of industry codes, Health and Safety legislation, and Development Consent Order. The TO would still retain overall responsibility for the project, and therefore would be liable for any regulations which are breached by the SPV. As many external stakeholders would not be familiar with the SPV model, the host TO would also be subject to any negative reputational consequences associated with the SPV's actions.

- The Impact Assessment recognises neither the risk associated with these breaches, nor the costs associated with activities such as monitoring and assurance which the host TOs would need to undertake in order to mitigate these risks.
- The host TO would also bear the risk of incomplete recovery of costs associated with running the tender process, and of revenue adjusting events during construction or operation.
- At the end of the 25-year contract period, the host TO would have to take over operation and maintenance of the assets. If, in order to achieve the low costs anticipated by Ofgem in its IA, these assets had been poorly designed and maintained then the TO may face unexpected costs associated with managing these assets.

(iii) Ofgem fails to consider the impact on TO financeability and credit metrics, and the costs associated with remediating this

- The presence of an SPV would negatively impact the host TO's financeability and credit headroom. Under accounting rules (IFRS16), the TO would record the future payments due to the SPV as a lease (i.e. a balance sheet liability similar to a debt) but there would be no offsetting asset such as a TO RAV addition: there would therefore be debt with no corresponding RAV. If the SPV payments are recognised as an asset in RAV, then the SPV would effectively be 100% geared. Lower gearing would need to be used elsewhere in NGET's portfolio to maintain its notional gearing level of 60% and associated investment grade credit rating.

(iv) Ofgem fails to consider the wider costs to consumers, e.g. to reflect the increased risk of delay to delivery, costs in the case of default of a highly geared SPV, or consumers potentially having to pay to replace assets sooner than under SWW

- As the SPV model describes a linear procurement process with multiple stage gates, it may result in longer lead times to project delivery, or costs being incurred ahead of the project need being confirmed. Project delays could lead to increased constraint costs being borne by consumers, or delay the connection of low-carbon generation to the grid.
- Ofgem has not factored in the increased likelihood of financial distress which could be experienced by SPVs due to their use of highly geared financial structures or mispricing of risk (due to "winners' curse"). Ofgem does not consider the consequences of SPV default, or the resulting costs such as TO step-in and the re-running of the SPV tender process.
- SPV financial distress may also result in the delivery of a low-quality product in order to reduce costs. Ofgem has not considered the increased costs which may be borne by the TO and consumers at the end of the 25-year contract period if poor quality assets need to be replaced.
- It is not clear that it would be in consumers' interests to pay back the costs of the SPV assets over a 25-year period rather than the 45-year period under the current RIIO deal, given the government's Social Time Preference Rate.
- High gearing results in reduced corporation tax payments: this is not a true benefit to consumers as the majority are also taxpayers.
- The Impact Assessment also does not take account of the wasted tender costs which would be incurred if the project need case disappears during the process. Under an SPV model, it is expected that the process of appointing an SPV would need to take place before conventional procurement would start under SWW: this means that it would take place when the project need and timescales are less certain. TO tender costs and bidder costs are still paid if a tender is cancelled: although not funding these costs would deter potential bidders and leave the TO with a funding gap, funding them would increase consumer costs compared to the counterfactual.

There are also a number of other effects which Ofgem needs to consider:

- There is a cost to consumers of bringing forward a new model part way through a price control. The introduction of SPV is inconsistent with the RIIO-T1 Final Proposals, which very clearly set out two alternative models for delivering Strategic Wider Works projects: either Strategic Wider Works, at the RIIO Cost of Capital, or via a competitive process to appoint a new TO licensee with the full set of direct regulatory controls and safeguards. By introducing the SPV model during T1, Ofgem would be creating regulatory uncertainty, reducing investor confidence, and increasing costs to consumers.
- By adopting a 'late model' of competition and considering the exclusion of legally separate TO affiliates from bidding, Ofgem is not consulting on an SPV model which would maximise the available consumer benefit.

Underpinning these concerns, it is not clear what total saving (in millions of pounds) Ofgem anticipates as a result of the SPV model. This means that it is hard to quantify whether it would deliver a net consumer benefit, when additional costs are factored into the analysis.

To note: Our comments on this Impact Assessment relate to the SPV model only. Although we have previously expressed concerns regarding the consumer benefit of the Competition Proxy Model, we note that a decision to apply this model to Hinkley-Seabank has already been made.

Appendix: Initial Comments on the Proposed Illustrative Licence Drafting

Reference	Issue
General	Would the general obligations set out in Parts A-F, I-L be better housed in a standard condition in Section D (applicable to all TOs) with the licensee specific revenue provisions (G, H) appearing in a special condition?
6M.1 and 2	Presumably 6I will also need to be amended in order to define Relevant Assets, Delivery Model and in order to give the Authority vires to specify an SPV or other delivery model for a particular relevant asset? Is it intended that the Authority will identify relevant assets and means of delivery under 6I? Note that the term Relevant Assets is already used in Condition A1.
6M.2	This refers to Special Condition 6I.42. We note that this condition does not yet exist.
6M.3	6M.2(b)(c) and (e) provide for production and updates of documents but there is no provision dealing with delivery to the Authority for approval under 6M.3. When would delivery be required?
6M.4	The timescales should be agreed with the Authority, rather than specified by it
6M.4	See comment above. There is no provision dealing with submission of documents for approval
Part B	Should this section dealing with obligations in the Tender Period also refer to obligation to continue with pre-construction where relevant? See 4.13 of the consultation document
6M.5(b)	Is it appropriate that there may be a material change to the proposed Relevant Asset after the Tender Period has commenced as contemplated here? One would expect the Relevant Asset to be baselined as final to inform the Tender Documentation and Delivery Agreement
6M.6	Can the Delivery Agreement materially change during the Tender Period? If so, presumably the licensee would need to submit a revised Delivery Agreement for approval. How does this impact on the Tender Period that has already begun?
6M.6	"Seek approval from" would be more appropriate than "notify"
6M.7	There should be a linkage between the Delivery Agreement being approved by the Authority under this provision (specifically the costs therein) and the licensee's allowances in respect of the Relevant Assets in Part G
6M.9	It would not be logical to simply re-run the same tender and expect a different result. It would be preferable to add a step reviewing the decision to implement SPV, or seeking feedback as to why the process has failed.
Part D	The circumstances in which the Authority can give a cancellation direction need to be specified in the licence to provide regulatory certainty. The treatment of licensee costs associated with the cancelled tender also needs to be addressed by way of a term within the licence.
6M.12	The terms of the Delivery Agreement would have been approved by the Authority. The Delivery Agreement should not therefore be on terms that place the licensee in conflict with any other "statutory obligations of the licence".
6M.13	What breaches must be reported to the Authority? Those made by the licensee, SPV or both?
Part F	The terms Construction Period and Operational Period need to be defined
6M.14 and 15	These conditions refer to licensee reporting requirements in relation to appointed SPVs. The licence condition should set out how often this reporting is required, and in which format.
6M.15	It is not clear why the TO would report the costs and debt position of the SPV, as they would not be expected to impact its revenues or allowances
Part G	Is it envisaged that <u>all</u> SPV transmission revenue (construction and operational) associated with (potentially multiple) SPV relevant assets is captured in this condition or will there be an SPV transmission revenue restriction for each individual SPV asset? Will the SPVC and SPV terms defined later in the condition apply to a specific project or, potentially, to multiple projects? Table X suggests the latter for operational period allowances, but clarification would be helpful. We will also require visibility of the proposed changes to SpC 3A which will be required, in order to ensure that the licence changes made are consistent with each other.
6M.16	Depending on the point above, should this refer to allowed revenue in respect of a specific relevant asset or is this covering potentially multiple SPV relevant assets?

Part G	Is it envisaged that the SPV Transmission Revenue terms will be captured in the TO Principal Formula in Special Condition 3A such that they are captured by that formula and therefore taken into account for Transmission Network Charge setting purposes? It is amounts derived from this principal formula that are notified to the SO by the TO under Special Condition 2N of the TO licence and recovered by the SO on behalf of TOs. It would seem that this linkage is required for the SPV revenues to be recoverable by the TO
6M.17	SPV Construction Revenue (SPVCc) will be collected within TNUoS revenues. TNUoS revenues are calculated by dividing the MAR by demand to create a per unit tariff. The amounts collected cannot be broken down into specific elements of TNUoS, thus the licensee cannot be asked to ensure that a specific element of TNUoS is collected correctly; this has to be done at a total level. The requirement to ensure accurate collection at a total level is already included within the TO licence (SpC 3A.2) for Transmission Network Revenue. Including this in the SPV condition would duplicate the licence and introduce a requirement that the licensee would not be able to fulfil.
6M.18	Please could you clarify what is meant by the concept of relevant years t and c.
6M.18	The KC term operates on a 1 year delay whereas the K term elsewhere in the TO licence adopts a 2 year delay. Should this be more consistent?
6M.18	There should be a term for the costs incurred by the TO in running the tender and monitoring activities. It is not clear whether this revenue would flow through totex and thus TIM. If so, specific allowances would be required. If not, a specific term would be required and the revenue included within the Revenue RRP as for other pass through costs or allowances (e.g. NIA). A specific 'price control mechanism' is noted at 4.46. Ofgem should consider whether T1 costs go through totex and TIM and if claimed during T1 or as a T1 true-up
6M.19	BRt (Base Revenue) is already a term within the NGET licence; the term for SPV Base Revenue will need different initials.
6M.19	It is not clear why the RIT terms uses a september RPI date when RRP RPI rates are from March. Further, we note that the licence text uses RPI although this policy decision has not yet been made.
6M.19	This introduces another K_t term: there will now be two k_t terms with different values in the licence.
6M.19	We assume that the reference to $OFTO_{t-1}$ is an error.
6M.19	When licence formulae are listed, they are usually done in the order in which terms appear within a formula. This has not been followed in 6M.19 and is confusing.
6M.19	PR term – if there is a partial year on commencement then surely there could be a partial year on completion which would need to be incorporated in the licence?
6M.19	A definition of Base Date would be needed for the term within the RIT formula
6M.19	The table should show the yearly revenue, where relevant
Part G	There is no provision for the recovery by the licensee of its own costs associated with the SPV tender and delivery agreement.
6M.17 and elsewhere	The use of the terms Relevant Year c is confusing. A Relevant Year t is defined in Special Condition 1A. Would it not be easier to refer to Construction Revenue (SPVC) and Operational Revenue (SPV) both in respect of relevant Year t (being the year in which a particular calculation is being made)? SPVC revenue may therefore be received during a relevant Year t in which construction takes place and construction costs are incurred. There are currently confusing references to both Relevant Year t and C (see 6M.18 for instance)
6M.18	Should refer to Construction Period Start Date (as defined)
6M.18	Should the RAC terms specify when a COAE has occurred? Must this be in the same year as the adjustment or can it be in a previous year?
6M.18 and 19	These conditions refer to the revenue which the TO would pass through to the SPV. There does not appear to be a mechanism to fund the TO for its activities, risks, or the impact on its financial metrics.
6M.19	BRt is already a defined term / concept (TO Base Transmission Revenue) used in Special Condition 3A. Suggest an alternative term is used such as SPVBRt?
6M.19	Tender Revenue Stream needs to be defined

6M.19	Is paragraph (a) in the term PRt required? 6M.19 specifies that SPV takes a value of zero for years preceding the Completion Year so it would not appear necessary?
6M.19	Further clarity is required in relation to the timing of events that might trigger an adjustment under RA, ITA or PA. Must these occur in the relevant year t or can they be in previous years but adjusted in / taken into account in a subsequent relevant year?
Table X and elsewhere	Project Name, Project and Relevant Assets are used in the drafting. Need consistency throughout.
Part H	The linkage between COAEs approved by the Authority (and the subsequent adjustment to the licensee's allowed recovery) and cost adjustments to the Delivery Agreement approved by the Authority under [6M.6] needs to be clarified. If Ofgem approves a DA cost adjustment then this needs to be mirrored in the amount of revenue that the licensee can recover to cover the tender revenue stream
6M.20	This condition should specify the timescales associated with the licensee applying for changes in relation to qualifying events.
6M.21, 27 and 28	These conditions are yet to be developed. We would like to have clarity on these licence conditions sooner rather than later, in order to assess the extent of risk which the TO bears.