Scottish & Southern Electricity Networks

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9 November 2018

Dear Matthew,

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

SSEN welcomes the opportunity to respond to Ofgem's consultation on the commercial and regulatory framework for the SPV model, and the supporting Impact Assessment.

We contend that the introduction of the SPV model to onshore transmission will fundamentally impact the security and operation of GB's critical national electricity infrastructure. On several occasions[1] we have outlined our significant concern that Ofgem's approach in developing this proposal is disjointed and ill-defined and will lead to material negative impact on consumers, network users and wider stakeholders, as well as the incumbent Transmission Owner/licensee (TO).

Our response clearly sets out where the proposals are deficient and, most importantly, where we foresee the downside risks will materialise.

We do not support the introduction of the proposed SPV model during RIIO1. We consider the model is not workable as a result of:

- The **complexity** and undeveloped state of the SPV model
- Undeliverable TO **obligations** and network **operational** conflicts
- Incorrect **financeability** conclusions
- Undeliverable **contractual** structure
- A deficient **procurement** process

[1] SHE-T responses to 30th August 2017 'Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models' and 23rd January 2018 'Hinkley-Seabank project: minded-to consultation on delivery model'

We have previously stated, and continue to believe, that **Ofgem does not have the necessary powers** to introduce this SPV model via the 'back-door'. Furthermore, correcting for errors in the published Impact Assessment, the conclusion of industry experts[2] is that this model will **increase costs** to consumers.

These conclusions are consistent with the response we provided to the Hinkley-Seabank (HSB) project in March 2018. We continue to oppose the introduction of SPV as an alternative delivery model, as the model is wrong in principle, lacks evidence, the process developing the model is insufficient, and the merits of the model have not been demonstrated.

Our submission to this consultation comprises:

1. Appendix 1: Detailed comments in response to the 'Extending competition in electricity transmission: commercial and regulatory framework for the SPV Model - Consultation' and our views on Ofgem's overall approach in developing the policy.
2. Appendix 2: We have commissioned jointly with Scottish Power Transmission (SPT) an update to the independent report undertaken by NERA and submitted as part of our response to Ofgem's January consultation on Hinkley-Seabank
3. Appendix 3: We have commissioned an independent report undertaken by Oxera on Ofgem's Impact Assessment for the CPM and SPV models

We have provided below, a summary of key issues which we believe create an unworkable SPV solution, however we encourage Ofgem to consider the appendices referenced above which cover in more detail our key concerns with the proposals.

Failure of the SPV model

Development

At present, we consider the proposals to be underdeveloped and ill-informed and, if pursued, will be to the detriment of connecting generators and ultimately consumers. It would be wrong for Ofgem to bring forward licence modifications at this early stage.

We do not believe that Ofgem has addressed or responded to the issues raised in our previous engagement. Therefore, we strongly urge Ofgem to carefully consider and respond to the points raised in this response and halt the introduction of SPV as an alternative delivery model during RIIO-T1.

Operational

There is no acknowledgement of the operational framework that an SPV would be obliged to deliver under. A workable operational framework is essential; its absence leads to the conclusion that the proposed TO-SPV relationship **will not deliver the quality and safety** of transmission outputs that our consumers require and rely upon.

[2] See independent consultant's reports in Appendix 2 and Appendix 3

It is not clear how the SPV would, or could, respond to a severe asset failure. Failure to consider the **implications of this on customer service and resilience** as well as the cost impact is a significant gap in Ofgem's SPV Impact Assessment amongst several other significant shortcomings we and our independent advisors have identified in the Impact Assessment.

We believe Ofgem has underestimated the day-to-day activities carried out by a TO in the operation and maintenance of the transmission network. The proposals under the SPV model do not support the **safe and efficient** operation of the GB transmission network.

Designing efficient and effective networks

There is an increasing requirement for a TO to consider the whole network and to be flexible and responsive in its planning activities. This includes identifying and then taking account of a wide range of possible scenarios to ensure economic, efficient and coordinated outcomes. Failure to consider how **integrated network planning** is achieved in the presence of dispersed SPV assets within, or bordering, existing TO and DNO networks is a significant gap in the proposed model.

Benefits of Regulatory certainty

We continue to believe that major policy change of this nature should not progress outside of the established price control framework and without **legislative amendment and scrutiny**. Furthermore, the prospect of its implementation on mature projects could lead to protracted regulatory process, risking **significant delays** to the delivery programme to the detriment of connecting generators and ultimately consumers.

Regulatory and Legislative underpinning

We believe that **Ofgem does not have the powers to proceed** with the SPV model.[3] Ofgem recognised that it is unable to run a competitive process for the award of a transmission licence without amendments to **primary legislation**. This should cause Ofgem to pause to consider whether it would be an appropriate, lawful and proportionate use of its licence modification powers to seek similar powers by the "back-door". In our view, the **SPV model is also inconsistent** with the intentions of Parliament set out in the **Electricity Act 1989**.

Contractual / commercial

The commercial framework that would be required between TO and **SPV will be extremely complicated** to ensure that all the normal TO responsibilities are split correctly between TO and SPV. The cost in doing so in contract specialists, solicitors and relevantly qualified and experienced TO employees will be significant and should not be underestimated. It is not clear how liability for all TO regulatory obligations can be addressed through a commercial contract, as well as how the transaction costs incurred would be apportioned. Effective contractual arrangements to address the split in TO-SPV obligations, absent the licensing of the SPV, are a

[3] https://www.ofgem.gov.uk/system/files/docs/2018/04/sse_appendix_2.pdf

necessary minimum to ensure **the requirements of customers do not fall** between parties and suffer as a result.

Revenue impacts

We continue to believe that reducing the period by which the cost of the asset is fully recovered will **increase the cost to consumers per year for that 25-year period**. We would welcome Ofgem's analysis on this point and how this intergenerational effect can be justified. This is particularly relevant given the evidence and outcome of the BGT appeal to the CMA on ED1[4] in relation to asset lives and intergenerational reference.

Deficient and poorly justified Impact Assessment

Ofgem's **Impact Assessment has several significant flaws** which substantially undermine the proposed net benefit to consumers attributed to SPV (and CPM). The Impact Assessment proposed by Ofgem when adjusted for several factors **demonstrates a net cost to consumers instead of a net benefit**.[5]

Notwithstanding the issues we have highlighted above, we have considered Ofgem's proposals for the commercial and regulatory framework for the SPV model, as set out in the consultation and supporting Agilia report and provide our initial comments in this response. Our response is not exhaustive, and we believe that there is need for significant review of the barriers created by SPV before any decisions are made by Ofgem.

It is disappointing that much of our response covers issues we have raised previously with Ofgem but which have not yet been either considered or sufficiently addressed within the documents published with this consultation or through any other appropriate means.

We look forward to the opportunity to discuss our concerns with Ofgem in due course.

Yours sincerely

Katherine Marshall

Katherine Marshall

Director of Regulation

[4] https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf

[5] See independent consultant's reports in Appendix 2 and Appendix 3

Appendix 1: Detailed comments in response to the 'Extending competition in electricity transmission: commercial and regulatory framework for the SPV Model - Consultation

1. SPV model is complex and underdeveloped

When Ofgem first proposed the SPV model for NGET's Hinkley-Seabank project in August 2017, it acknowledged that a significant amount of work would be required to develop the policy framework for the model. Over a year later, there remains significant uncertainty attached to the contractual and regulatory policy framework. Ofgem's most recent publications highlight this and we expand on these points in our response. The current consultation does not address the material issues which prevent the effective introduction of competition through an SPV model. We do not consider that the model proposals can be adapted to bridge these gaps.

In particular:

- Ofgem has not engaged in any meaningful way with the concerns raised by the TOs to date. Within its consultation, Ofgem refers to the fact that "*TO participants expressed a range of concerns with the introduction of the SPV model, including issues around standards, the efficiency of appointing a third party to deliver the projects, and their exposure to a range of risks*". **However, no further detail on the concerns raised is given.**

- Ofgem states that Agilia "*considered the above feedback in pulling together their proposed commercial framework*". **There is no evidence that Agilia has done so.**

- More importantly, it is Ofgem's responsibility to consider these concerns and it would not be appropriate for Ofgem to delegate this role to Agilia.

We are disappointed to see that whilst Ofgem is now consulting on the commercial and regulatory framework for the SPV model, it has still not set out nor consulted on the operational framework that would be needed to facilitate the model. We can therefore only assume that Ofgem has not yet considered these issues. As such, we have taken this opportunity to bring to Ofgem's attention some of the many operational compliance risks associated with the proposed SPV model.

- **We are surprised and concerned that Ofgem intends to bring forward licence changes in Q1 2019, to implement the model and apply it to SWW projects which have or will be brought forward under RIIO-T1.**

2. Undeliverable TO obligations and network operational conflicts

SSEN considers that the introduction of an unlicensed third party has substantial practical implications that can, and will, lead to detrimental impacts on the quality of service of the transmission network. Ofgem has not adequately assessed and quantified the compliance risks

associated with the proposed SPV model and therefore has failed to accommodate these within its assessment of consumer benefit. We explain and demonstrate these points below:

2.1 Suitability of an unlicensed SPV

Legitimate network entities must have the capability and capacity to deliver

The transmission network is a dynamic, active system, which can be volatile to operate. In addition, the electricity network is continuing to become increasingly complex, a change which is recognised by Ofgem in its current work on RIIO2. The introduction of DSOs and market developments/technologies, such as smart meters, active network management, demand side response, increasing battery storage and real-time dynamic energy pricing is adding more complexity to this active system, which is getting harder to secure and operate. The historical evidence of the impact on the transmission network and the implication of these changes on future operations should be considered very carefully by Ofgem. Given the substantial rate of change we, as a TO, have experienced on the network, it is unlikely that an SPV asset will remain unaffected over a 25-year period.

We would expect that third parties appointed through the SPV model would need to be of a similar scale, financial standing and size to fully regulated Network Operators with knowledge and experience in designing/owning/operating critical UK infrastructure. For this reason, we have argued consistently that the **only effective solution is the development of a CATO model**.

2.2 Efficient and safe operation

Clarity and certainty over control and responsibilities is crucial for network operation

We believe that the proposals concerning the effective operation of the SPV asset conflict with the duties of existing industry parties. The inconsistency and conflict within the proposals as set out in the consultation lead to the conclusion that the model is not workable.

Operational control: It is important to clarify that whilst the onshore transmission network is owned and maintained by regional TOs, '*operational control*' lies with the ESO, National Grid Electricity Transmission, who is responsible for ensuring the stable and secure operation of the GB transmission system. A TO's transmission assets can be utilised by the ESO as it sees fit, for example, for voltage control to manage short term issues on the network.

Inconsistent proposed obligations: Ofgem's proposals are inconsistent. Between the consultation document and Agilia report, there are contradictions which require urgent clarification.

- Within the Agilia report, the TO's '*Service Period Obligations*' are listed to include the responsibility to carry out its business-as-usual obligations as the transmission licensee, including being the "*operator of transmission assets (and comply with the associated regulatory obligations)*", whilst the SPV's responsibilities are limited to maintaining the transmission asset.
- The Agilia report also suggests that the TO will receive a regulatory income in respect of the transmission asset, though it is not clear if this is simply the income that the TO must

pass to the SPV, as proposed by Ofgem, or an income for operating the asset. Within the consultation, Ofgem suggests that there will be just two areas where costs could arise for the TO; costs associated with developing and running the SPV tender, and costs associated with the ongoing management of the SPV. There is no suggestion that the TO will receive an operational allowance for the SPV asset.

Conflicting proposed obligations: Ofgem proposes that while "*overall regulatory responsibility and operational control*" of the transmission assets will remain with the TO, the SPV will be required to "*operate and maintain*" the transmission assets. Ofgem states that it expects "*the SPV would have responsibility for the day-to-day O&M of the assets, and that it should be allowed to perform its functions under the DA without undue interference from the TO*." What this means in practice has not been addressed by Ofgem in any publications on the SPV model to date, which is of increasing concern.

Absence of operational framework: There is no acknowledgement of the operational framework that an SPV would be obliged to deliver under. As a licensed TO we have a duty to operate and maintain the transmission network efficiently and safely to the benefit of GB consumers. Does Ofgem propose that this responsibility is transferred to an SPV, and if so, what does Ofgem consider the day-to-day operation and maintenance of transmission assets to include? A workable operational framework is essential to understand whether the TO-SPV relationship can deliver the quality and safety of transmission outputs that our consumers require and rely upon.

2.2.1 Safety and security through rapid response

Resilience is key to ensuring a safe and secure network for our customers.

Our experience confirms that storm and other unpredictable networks events have the potential to lead to material and serious harm. Existing TOs have developed the ability and capacity to provide effective rapid and targeted response to such events. The current SPV proposals do not resolve how a SPV would respond in a storm event where rapid action is required and access to the affected asset could be difficult.

Example - storm planning and response by network operators. Typically, when a storm is expected, a TO will deploy its engineering resources, sending them to remote locations in anticipation of the storm causing network issues and to ensure the asset can be returned to service in the shortest possible time. If this approach is not taken, then the same weather event can prevent engineers reaching the asset for many days. This planning is essential to keep customer's lights on or minimise the time where customers are off supply.

Example – severe asset failure: Fault scenarios on an asset, for example an overhead line, do occur and can range from relatively simple non-urgent single insulator damage which may not require immediate replacement and can be dealt with at the next maintenance outage, to serious line icing, conductor damage and even tower collapse. Whilst extremely rare, tower collapse is not an extraordinary event given the weather extremes that the SHE Transmission network encounters.

As an example, SHE Transmission recently had two 132kV towers collapse in exceptional weather conditions in Kintyre. Following the extreme ice loading and snowfall SHE Transmission had to mobilise maintenance and operations teams to carry out temporary and then permanent repairs to enable staged restoration. This work included provision of system analysis, engineering design, technical approval, operations and on-site supervision to facilitate repairs and temporary power supplies to ensure that customer supplies, particularly vulnerable customer supplies, were restored in a timely manner. Substantial internal and external resource, along with the provision of plant, materials and emergency restoration spares were deployed to ensure timely restoration.

SHE Transmission worked very closely with the Distribution Network Operator, SHEPD, in a co-ordinated manner to minimise disruption to the domestic and commercial customers connected at Grid Supply Points at the radial extremities of this part of the network.

Notwithstanding the points above on clarity of operational control, it is not clear how under the SPV proposals the entity would or could respond to a severe asset failure. Failure to consider the implications of this on customer service and resilience as well as the cost impact is a significant gap in Ofgem's SPV Impact Assessment.

SPV capability: Maintaining safety and security will be a challenging task for a standalone SPV with potentially limited depth and breadth of resource and experience, and with limited access to spares and emergency resource arrangements. Considering the potential for such a scenario raises several critical questions which are not addressed in Ofgem's proposals. For example:

- Would the SPV be required under contract to have the contingency resources, equipment, and spares holdings to deal with this?
- How quickly could the SPV respond and what incentive does the SPV have to respond? What would be the impact on customers and constraint costs for the System Operator? How would any failure to respond affect the TO's regulatory obligations and incentives?
- How would the SPV be funded for such an event?

2.2.2 Daily management of the network

A SPV must be resourced to deliver daily operational requirements

We believe Ofgem has underestimated the day-to-day activities carried out by a TO in the operation and maintenance of the transmission network. This urgently requires review by Ofgem as failure to do so will not provide comfort that the proposals under the SPV model are not to the detriment of the **safe and efficient** operation of the GB transmission network. We have provided a non-exhaustive list of just some of these activities below which have not been considered in the development of the proposals and, which, unresolved, prevent the adoption of the SPV model.

Emergency and safety activities:

- 24-hour cover for field resources and office hour correspondence for outage planning responsibilities.

- Who is responsible for safety under the SPV model? On an Enhanced Over Head Line (OHL) construction, who will check, design and maintain safety clearances though the 25-year revenue term? Who is responsible for anything infringing on these clearances? Who is ultimately responsible in the event of an accident or fatality?

Daily efficient operation of network assets

- OHL circuit ratings to help minimise constraint costs. This can have site/public safety implications if not managed and monitored correctly.
- Asset checks, such as helicopter patrols, on circuits which will be key to securing parts of the network prior to taking outages on neighbouring circuits.
- To deliver Totex efficiency, maintenance is often planned to align with projects and, project outages often need to change. As a TO, we ensure alignment is maintained wherever possible. An SPV with limited operational resources will not be able to absorb the cost of this flexibility as incumbent TOs currently do. This introduces inefficiencies into the network operation and can lead to lowered system availability thus increasing constraint costs, particularly if the asset was on a high cost boundary.
- Black start - If SPV assets form part of a Local Joint Restoration Plan (LJRP), they constitute critical assets and must be maintained robustly to a high standard, along with all associated operational factors such as communications and back up site supplies. For such assets the SPV would require the facility to respond 24/7 to the possibility of a Black Start, again a resource requirement which will add costs and complexity to the operational delivery of this.
- If the SPV is responsible for responding to fault scenarios, this could increase the TO's Energy Not Supplied risk and ESO constraint costs if not resourced and managed appropriately by the SPV. And who pays for this?

Interaction of industry parties

- Given the current proposals that the SPV will not hold a licence, there will be no relationship between the ESO and the SPV. The SPV model does not consider how operational instructions for switching the SPV asset will be relayed from the ESO through the TO to the SPV, nor does it consider cost implications, responsibility for the communication of instructions or consequence of failure.
- Under common operational conditions, such as if there is ice loading or smoke from stubble burning affecting an overhead line asset, it is unclear how or whether the SPV will determine an appropriate derating and inform the TO so the ESO can be notified and reduce capability.
- In the event that one of the two installed OHL protection systems on an overhead line are faulty or unavailable, the proposals do not consider how the TO and ESO are informed and which party decides whether the risk of keeping the OHL in service is acceptable and the resulting capability.

2.3 System Planning and Reinforcement

Network development is driven by obligations placed on the TOs pursuant to the Electricity Act 1989 and under licence. Primarily driven by customer connection applications, network development and reinforcement require considerable system planning to facilitate in an economic and efficient manner. Feedback from stakeholders confirms the emphasis and value they place on efficiency and timely progress of system reinforcement requirements.

2.3.1 Customer Connections

A SPV must meet its customer's service expectations

The TOs and the ESO have statutory and licence obligations to respond to connection applications within a 90-day period. If this involves connection to an SPV asset, the process could become more time consuming and unmanageable within the mandated timescales by having to consult with the SPV to agree design proposals, scope of works, interfaces and potential changes to the DA with the TO.

If a customer or several customers are connected to a SPV asset, and are unhappy with their connection, for example, if they have an active network management system and their access is not what was expected, it is not clear if the SPV would be responsible for handling these complaints directly and resolving the issues.

2.3.2 Designing efficient and effective networks

A SPV must have the capabilities and skills to achieve effective system planning

Network development against an uncertain background of generation/demand is complex and requires many different scenarios to be evaluated. Current TOs maintain significant network planning functions. This enables consideration of non-build Network reinforcement solutions such as inter-trip and active management solutions alongside more conventional reinforcement options. This can further increase complexity and risks in operational timescales. There is therefore an increasing requirement for the TO to consider the whole network and to be flexible and responsive in planning the network, considering a wide range of possible scenarios to ensure economic, efficient and coordinated outcomes.

There has been a high rate of investment in the transmission network over the last c.15 years, driven primarily by renewable generation. Our experience tells us that investment planning needs to be able to react quickly to unexpected changes or changing trends in a given area.

The actions of a large generator (or several small generators) connecting or terminating can result in a change to the design of a network asset or even a wholesale change which in turn requires a completely different operating voltage and tower suite with differently specified switchgear and transformers. Consequently, a network design might require change (large or small) between the pre-design and execution phase of a project. It is not clear how the SPV model can accommodate this flexibility in network planning or remove obstacles in trying to accommodate changes to the network.

Example – response to network investment: A recent example of sudden change to the network arose when the system operability at light loads was identified as an issue for the ESO.

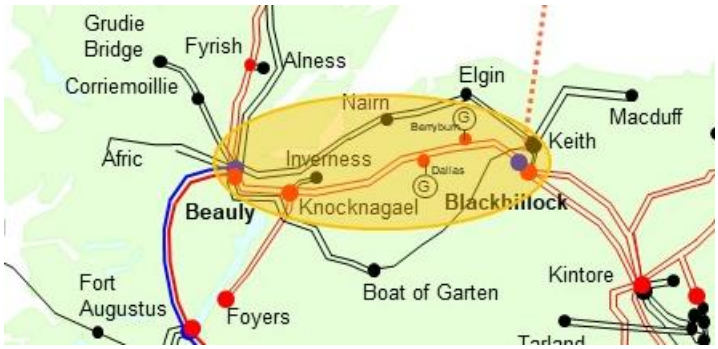
Additional reactive compensation was required to maintain the network within critical voltage and current limits. This required the urgent installation of three 132kV reactors on the SHE Transmission network to allow the ESO to operate in a secure manner. Additional reactive compensation was installed by the other TOs.

Another example of network change is the addition of phase shifting transformers as an incremental reinforcement. As a TO, we have added several over the years, to optimise network flows and maintain system security. It is unclear how these types of changes would be accommodated on an existing SPV asset, and who would be responsible.

These examples raise significant questions of the proposed model in the event that a SPV asset requires to be replaced or significantly modified; who will be responsible for undertaking these works and how will this be managed under the existing 25-year DA between the SPV and the TO?

Example – SHE Transmission experience: To illustrate this point, we have provided a real example of the rapid changes that can occur on a specific asset in Figure 1 below.

Figure 1: Beauly – Blackhillock reinforcement



Reinforcement work has taken place on the overhead line between Beauly and Blackhillock (B-B), over a relatively short period from 2009 to 2018, as a result of (i) required load driven reinforcement, (ii) new renewable generator connections.

1. **2009** - New 275/33 connection for Cairn Uish windfarm. Installation of a new 275/33 kV substation called Dallas on the B-B line.
2. **2011** - Load related reinforcement: Installation of 400kV ready Knocknagael substation on B-B, where the Foyers 275kV circuits join B-B.
3. **2013** - New 275/33 connection for Berryburn windfarm. Installation of a new 275/33 kV substation called Berryburn on the B-B line.

4. **2014** - Load related reinforcement: Installation of new high capacity conductors to replace existing conductors on the whole line between B-B, including tie-in to Knocknagael.
5. **2018** - Load related reinforcement: Complete rebuild and reconfiguration of Blackhillock substation involving moving B-B overhead line towers for entry, as part of Caithness-Moray.
6. **2023** - Future new connection for Clash Gour windfarm to B-B.

To meet the expectations of customers a SPV model must ensure the entity has the capability to respond quickly, effectively and with an efficient solution to network events such as that illustrated above. The current model does not demonstrate how this is achieved.

3. The consumer benefits of Regulatory certainty

Ofgem has recognised that regulatory certainty leads to benefits to customers

We continue to believe that major policy change of this nature should not progress outside of the established price control framework and without legislative amendment and scrutiny. Furthermore, the prospect of its implementation on mature projects could lead to protracted regulatory process, risking significant delays to the delivery programme to the detriment of connecting generators and ultimately consumers.

Foundation of RIIO: Clarity and certainty in the regulatory framework is vital for licensees, generators, customers and all relevant stakeholders including investors, particularly when this underpins the financing, construction and operation of new transmission assets. The need for regulatory certainty for all affected parties was recognised as a **founding principle in the RIIO-T1 price control settlement** for the eight-year period 2013-2021 and was the rationale for the introduction of the existing Strategic Wider Works (SWW) uncertainty mechanism[6] which is subject to the same financial parameters as the broader price control[7].

Effective existing mechanism: The carefully developed SWW mechanism is designed to protect the interests of existing and future consumers by allowing reinforcement or development of the transmission system, unforeseen at the point the price control was set, to proceed only where the 'need' is demonstrated. It promotes competition to the extent appropriate, consistent with the TOs' statutory duties to develop and maintain an efficient, coordinated and economical transmission system, facilitating *supply* and *generation* competition (there is no statutory obligation to promote competition in *transmission*). The consequences for non-delivery under the SWW mechanism are transparent and accountability is clear. Furthermore,

[6] *https://www.ofgem.gov.uk/electricity/transmission-networks/critical-investments/strategic-wider-works*

[7] *Appendix 2; p58; para 1.5 - RIIO-T1 Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd; 23 April 2012*

this mechanism is sufficiently flexible allowing the TO to integrate mitigation measures or changes in design arising from unforeseen issues associated with the reinforcement.

Proven delivery: SSEN has demonstrated, through the RIIO-T1 period, a track record for delivering complex projects, in challenging environments, many of which carry significant risks, on schedule and within agreed allowances. TOs are already required to competitively procure construction works and any operation and maintenance services relating to their assets where this is not undertaken directly by the TO by virtue of the Utilities Contract Regulations 2016 ('UCRs'), and SSEN has consistently shown how the current approach under the RIIO framework provides powerful incentives for efficient delivery. For example, consumers have benefitted through the sharing mechanism under the terms of the price control where additional costs or savings are shared between the consumer and TO.

We consider that the effect of implementing the proposed SPV model to such high value transmission assets would be to remove critical infrastructure from the protection of the RIIO price control and regulatory oversight. Without this protection, risks are increased for existing and future consumers, who ultimately benefit from these investments.

As we have outlined previously[8], SSEN continues to believe that the adoption of the proposed SPV model, and any other alternative approach to the SWW mechanism, can only be considered a reopening of the RIIO T1 price control, likely to undermine investor and stakeholder confidence, with all the consequential adverse effects on TOs, consumers and other interested parties. Ofgem is yet to show it has given due consideration to these matters (as it is required to in its role as regulator) or present sufficient evidence to demonstrate how these risks will be mitigated under the SPV model whilst still delivering the ascribed benefits detailed in the Impact Assessment. We cannot see, based on the proposals presented in this consultation and the Agilia report, how the SPV model will deliver the same or improved benefits to existing and future consumers. As we outline separately with supporting evidence from NERA and Oxera, **it is more likely there would be a net cost to consumers rather than a net benefit**, despite Ofgem's Impact Assessment arguing the contrary.

4. Regulatory and Legislative underpinning

Proposed SPV model does not fall within Ofgem's powers and introduces unforeseen consequences

We believe that Ofgem needs to consider very carefully whether it has the powers to proceed with the SPV model. The fact that Ofgem has recognised that it is unable to run a competitive process for the award of a transmission licence without amendments to primary legislation should cause Ofgem to pause to consider whether it would be an appropriate, lawful and proportionate use of its licence modification powers to seek similar powers by the "back-door".

[8] SHE-T responses to 30th August 2017 'Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models' and 23rd January 2018 'Hinkley-Seabank project: minded-to consultation on delivery model'

In our view, the SPV model is inconsistent with the intentions of Parliament set out in the Electricity Act 1989.

Inconsistency with existing TO duties: The SPV model involves the imposition of a duty on TOs to facilitate competition in transmission even though the statutory duty imposed on TOs by Parliament is to facilitate competition in the supply and generation of electricity only.[9] The model also involves the imposition of obligations on TOs that interfere with their property rights, in spite of the absence of a statutory transfer scheme (as was envisaged in the draft CATO legislation) and the absence of a power to impose such a licence condition (in contrast to the position in respect of smart meter communication licences).

It also undermines the security of supply benefits provided by the special administration regime as there may be some important resources that are beyond the reach of the administrator, which would not be the case with a ring-fenced, licensed TO.

Finally, it undermines the way in which the UK has implemented its obligations under the Third Energy Package, as the UK's implementation focused on licensed entities only, as there would have been no expectation at that time that unlicensed entities would have significant rights in respect of transmission systems.

The OFTO regime, to which Ofgem considers there are many parallels in its current proposals, operates within a licensed regulatory framework which has been developed via the correct and appropriate mechanisms, following the primary legislative process, parliamentary scrutiny, and subsequent public consultation. That framework both mitigates the risks involved with regulatory uncertainty and, as a result, encourages investment in industry. Development of the SPV model without such a framework fails to achieve the similar balanced outcome.

Inconsistent with existing licence conditions: The SPV model undermines the licensing framework provided for by the Electricity Act 1989. If Ofgem is correct that the activities carried out by the SPV are not themselves licensable, the SPV model moves key parts of the operation of the electricity transmission system outside Ofgem's direct control, as Ofgem will not be able to exercise its wide-ranging enforcement powers directly against the SPV. This is an unacceptable regulatory risk for a TO.

Ofgem has also assumed in its consultation document, that there is no requirement for change to the standard conditions of the TOs' licences. This will require careful review and an understanding of what consents Ofgem intends to provide, but several issues are immediately apparent in Part B of the standard conditions, for example in respect of any relinquishment of operational control of relevant assets to the SPV (SLC B3) and any cross-default obligation contained in the DA (SLC B9).

The implications and impact of reflecting these changes within the licence could have wider and negative impacts on the existing TO networks. Ofgem has not considered whether the proposed SPV model is consistent and complementary with current licences.

[9] S. 9(2) Electricity Act 1989

5. Deficient and poorly justified Impact Assessment

A corrected Impact Assessment leads to the conclusion that SPV does not benefit customers.

Ofgem's Impact Assessment (IA) document has several significant flaws which substantially undermine the proposed net benefit to consumers asserted by Ofgem of SPV (and CPM). Although Ofgem refused to provide the Cost Benefits Analysis (CBA) or any related financial analysis supporting the IA, it is possible to at least partially replicate Ofgem's IA methodology. In a report provided by Oxera[10], it concludes that the IA proposed by Ofgem when adjusted for several factors demonstrates a net cost to consumers instead of a net benefit. This evidence illustrates the incompleteness of Ofgem's IA that has been used to justify the introduction of SPV (or CPM) for the benefit of consumers. We have not summarised Oxera's findings here in detail and refer Ofgem to the report provided alongside this response.

In addition, the introduction of "efficient" and "inefficient" delivery for SPV implementation gives rise to several questions. How does SPV procurement compare to the incumbent TOs current procurement process? How would this give rise to cost savings from the same market of participants who compete for construction of transmission infrastructure? How would these participants alter their behaviour and return requirements if their risk profile is not materially altered by the introduction of a one-off SPV tendering process or the right to a future revenue stream of one asset? Notably, Ofgem has not set out whether and how TOs are performing on tendering and therefore concluding that an SPV model would be implemented more or less "efficiently" than current competitive procurement arrangements, pursuant to legislative requirements, is unjustified.

We refer Ofgem back to our previous concerns regarding the SPV model[11], including the asset capital and operating cost savings for the interest of brevity. These concerns remain and require an adequate response from Ofgem.

6. Incomplete Financeability Assessment and Conclusions

Ofgem has reached the wrong conclusion by relying on its financial assessment which is limited and unclear at best.

As set out in our submission in March 2018, there are significant complexities with the SPV model, where such an arrangement as proposed would be deemed a Finance Lease under the conditions of IFRS 16. This means that it is highly likely that the liabilities would be borne on the incumbent TO's balance sheet therefore stretching its financeability metrics. Current licence conditions require TOs to maintain an investment grade credit rating, which includes restrictions on leverage as one of the key metrics, alongside interest cover. This has not been addressed at all under Ofgem's proposals, and the allocation of risks and liabilities is

[10] Oxera: 'Review of Ofgem's Impact Assessment for CPM and SPV models', November 2018

[11] SHE-T responses to 30th August 2017 'Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models' and 23rd January 2018 'Hinkley-Seabank project: minded-to consultation on delivery model'

incomplete. In discussions with various lenders it is clear that, in simple terms, the obligations and risks would reside with the TO and, as such, it would be difficult to consider this as anything other than a cross default obligation when assessing the financeability of the incumbent TO.

Separately, lenders outlined that they would view the SPV as significantly higher risk than an incumbent TO, in contrast to Ofgem's supposition, and therefore would likely require a higher interest rate to reflect that greater risk profile. We have outlined to Ofgem on several occasions that a one-off SPV with a single asset and significant operational risk, with limited regulatory protections, a focus on cost containment, higher leverage, and a low rate of return on equity, would be subject to higher default risks. This has not been considered by Ofgem and no evidence has been provided in relation to the risk profile of an SPV and the impact on the weighted average cost of capital (WACC). This component has been comprehensively outlined by NERA both in its original report to our March submission[12] and the update report to this consultation[13].

In its report, NERA clearly sets out that the rate of return proposed by Ofgem and their advisors, CEPA, is materially flawed, including CEPA's use of OFTOs as a benchmark. We have previously stated that the OFTO regime and how it is financed is an inappropriate benchmark for several reasons, including it being a single operational asset with a single point customer. This is in addition to the fact that publicly available evidence illustrates that the net benefit of OFTOs is overstated, as set out in the National Audit Office (NAO) report, 'Offshore electricity transmission: a new model for delivering infrastructure' from June 2012 and referred to in our March 2018 response and NERA's supporting analysis. The further analysis provided with this response from Oxera and NERA demonstrates that the OFTO evidence is insufficient, is an inappropriate comparator, and should not be relied upon in the assessment of the current proposals for onshore transmission investments for various reasons, but not least because of the significantly different risk profile and the implied rate of return.

7. Contractual arrangements

Contractual barriers to SPV model

Overall, we believe the commercial framework that would be required between TO and SPV will be extremely complicated to ensure that all the normal TO responsibilities are split correctly between TO and SPV. The cost of doing so in contract specialists, solicitors and relevantly qualified and experienced TO employees will be significant and should not be underestimated.

[12] NERA Economic Consulting: 'Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments - A report for SHET plc and SPT plc', March 2018
[13] NERA Economic Consulting: 'Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments - A report for SHET plc and SPT plc', October 2018

SSEN, as well as the other TOs, has previously raised concerns regarding the inherent difficulties with the proposed SPV model[14] and we have provided further detailed comments in response to Question 1 of the 'Commercial Framework'.

It is not clear how liability for all TO regulatory obligations can be addressed through a commercial contract, as well as how the transaction costs incurred would be apportioned. We believe it unlikely that any third party 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.

8. Revenue recovery and the impact on use of system charging

Failure to consider intergenerational revenue impact

Ofgem proposes that the SPV competition would determine an annual revenue stream for the project, reflecting the underlying capital and operational costs and WACC. This would be fully recovered by the TO 'from users of the system (and ultimately from consumers)' through its transmission licence and subsequently paid to the SPV over a 25-year period.

In the development of the RIIO price control, Ofgem reconsidered the appropriate level of 'asset lives' for the purpose of calculating depreciation and after a prolonged consultation period Ofgem opted to follow a 45-year asset life for RIIO-T1 and RIIO-ED1.

Ofgem has still not fully considered the implications of moving to a 25-year revenue recovery period for connecting customers and the consumer. We note that Ofgem has acknowledged this is a concern, in its 30 July 2018 decision document on the delivery model for Hinkley-Seabank. Ofgem's view is that consumers will 'benefit significantly overall', though over what period and to what extent it is unclear, and that there will be limited impact on intergenerational equity, though again 'limited impact' has not been quantified and would need to be considered on a project by project basis by Ofgem.

These impacts appear to be dependent on several assumptions and have not yet been considered fully. To illustrate:

- Any such impact would depend on the proportion of TNUoS being recovered via locational charges from connected parties.
- Conversely, we expect the impact on consumers will be dependent on the proportion being recovered by residual charges.

[14] SHE-T response to 30th August 2017 'Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models'

- More fundamentally, we assume that *any* savings will be dependent on the overall cost of delivering the asset through the SPV model versus the RIIO SWW mechanism, **which has yet to be quantified.**

We have previously raised our concerns on this matter[15] and continue to believe that reducing the period by which the cost of the asset is fully recovered, as proposed under both the SPV and Competition Proxy (CPM) models, will make the cost to consumers more expensive per year for those 25 years and urge Ofgem to undertake further analysis on this point.

9. RIIO-2

SSEN maintains its previously stated position, that the adoption of an alternative approach to the SWW uncertainty mechanism to be a reopening of the price control and its parameters.

- **This will undermine investor and stakeholder confidence, with all the consequential adverse effects on TOs, consumers and other interested parties.**

We refer Ofgem to the SHE Transmission response to the HSB minded to consultation dated 20th March 2018, the extensive analysis contained therein, and resulting questions raised by those proposals, many of which are reiterated in this response, and many of which Ofgem and Agilia have failed to acknowledge or address in this further development of the competition proposals.

Ofgem's approach is now affecting the development of the RIIO-2 framework, where there has been minimal development in its competition proposals to date. TOs are preparing business plans for the next price control now, which cannot reasonably take into consideration the potential impact of competition until Ofgem has addressed the many legitimate concerns of the current SPV or CPM proposals adequately, undertaken a robust impact assessment, and finalised its policy as well as the regulatory and contractual framework required to implement any such policy.

We remain firmly of the belief that the RIIO-2 framework development workstream is the most appropriate way to facilitate a transparent and robust consultative process, in which all parties can participate, and which, in turn, gives Ofgem the appropriate platform to pursue legitimate and considered alternatives to SWW.

- **It is fundamental to the development of a robust price control framework for RIIO-2 that Ofgem refocuses its competition objectives to this forum and allows sufficient time for the impact of any proposals to be fully reflected in the resulting business plans. It should achieve this by abandoning current plans to introduce alternative models during RIIO-1.**

[15] Section 3.1 of SHE-T's 23rd January 2018 'Hinkley-Seabank project: minded-to consultation on delivery model'

Consultation questions

COMMERCIAL FRAMEWORK

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

SSEN, as well as the other TOs, has previously raised concerns regarding the inherent difficulties with the proposed the SPV model[16]. The Ofgem consultation and Agilia report again fails to give sufficient consideration of the impact of the allocation of obligations and responsibilities as will be necessary under the Delivery Agreement (DA). As such, it remains unclear how liability for all relevant TO regulatory obligations can be addressed through a commercial contract. We consider it highly unlikely that a SPV would be prepared or able, pursuant to the terms of its financing arrangements, to accept the indemnification requirements, enforcement rights or change mechanisms that would reasonably be required by the TO to back off its risk, under licence, of SPV failure.

Given the potential length of the DA, and the inherently unpredictable nature of development and reinforcement of the transmission network, there would need to be careful consideration and structuring of the change mechanisms required within the DA. This would likely be complex, requiring heavy negotiation, and would undermine any notion of a fixed price, known risk contract, both for the TO, and the SPV and its investors.

We note that the initial contracting principles, set out by Agilia, replicate the provisions of a PF2 contract and, as such, are likely to initially appear attractive and familiar to potential SPV bidders. However, aside from the fact that the Government has recently committed to abolish the use of PFI contracts for projects, on the basis that they have locked public authorities into long term, inflexible and expensive arrangements, PFI/PF2 are not suitable comparators in terms of contracting structure as they are designed for use in single asset projects. They are not intended for use in complex and evolving networks.

The period of operation under the DA has been given little thought or definition in the current proposals. In addition, there are conflicting provisions between the Ofgem documents and the Agilia report as to who has '*operational control*' of the asset. We have provided further detail on this point in section 3 above, 'Undeliverable TO obligations and network operational conflicts'. As a result, it is not possible for any party to adequately consider or meaningfully quantify the risks associated with that element of the DA. Clarity as to what is meant by '*operation*' is critical, as it is inextricably linked to the appropriate allocation of obligations, and the associated enforcement and incentive mechanisms, both contractual and regulatory.

The TO may feel that it cannot accept the regulatory risk of the SPV failing to comply with its obligations under the contract and put in place its own measures to avoid any regulatory penalty, ultimately resulting in additional cost. It is unclear how this risk would be mitigated to

[16] SHE-T responses to 30th August 2017 'Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models'

the satisfaction of both the TO and SPV without the additional cost having to be borne by the consumer.

Ofgem is yet to provide any further information to support its proposal that, under the SPV model, all contracts, entered into by the TO, will be novated to the successful bidder. We have previously expressed our concern that, in practice, this may be more challenging than Ofgem suggests, particularly in projects which are already at the final needs case stage.

Many of the pre-construction works, where undertaken externally, will have been done based on contractual arrangements where the incumbent TO is the recipient of those works and services. These contractual arrangements are likely to require the TO to seek prior authority from the service provider to any publication of any associated documents or designs in a data room (with multiple parties potentially relying on these to form the basis of their bids), let alone any proposed novation. In considering whether to consent, the service provider will likely have to consult with its insurers, as it would not have been foreseen at the time it entered into any contractual arrangements with the TO that there could be multiple unknown parties relying on the works/services being provided. This will take time and will, likely, require contract amendment and result in an increase in insurance premiums for the service provider, which it would seek to recover from the TO.

It is important to recognise that there are differences in planning/consenting arrangements between jurisdictions that may preclude or complicate the transfer of contracts relative to securing wayleaves and land in Scotland. Under the SPV model, the TO would be responsible for negotiating these agreements, or applying to the Scottish Ministers for any compulsory rights that may be required, and any proceedings would be conducted by them. There is a potential for objections to be pursued in such processes if those affected adopt a view that the SPV, who will ultimately be responsible for delivery of the infrastructure, is not involved in the process. It is possible that agents, acting for affected landowners, could seek to impose financial obligations on the TO or SPV to make additional payments to secure the transfer of any arrangements to a SPV. There is also the concern that if a landowner chooses to terminate a wayleave once the infrastructure is operational, then the SPV may not have the powers under the Electricity Act to apply to retain the infrastructure. As stated previously, it is our opinion that a detailed review of issues in this area is undertaken as a matter of urgency.

Further consideration must also be given to the 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 which in the model envisaged will be undertaken by the TO. Generally, details of the construction process (which requires early input of the party constructing the asset) and specific mitigation measures to be deployed on the project must be included within the relevant application. In our experience, this is rarely a straightforward task and would be made more complicated when the party responsible for constructing the asset (the SPV) is not engaged, which would be the case under the SPV model proposed.

If a Public Inquiry is necessary to determine a section 37 or planning application, there is the potential for grounds of objections by those parties who feel that the application is not being given sufficient scrutiny if the party who will be ultimately responsible for delivery of the project is not part of the proceedings. We would suggest that there must be engagement with both BEIS and the DPEA to ascertain their views on this.

TOs are already required to competitively tender works, supplies or services, they may need to source externally, pursuant the Utilities Contracts Regulations 2016 and equivalent Utilities Contracts (Scotland) Regulations 2016 (*Note: this will also be a requirement for any tender process to appoint an SPV*). These legislative regulations require the TOs to conduct such procurements in a non-discriminatory and transparent manner, providing for equal treatment and fairness throughout that process, with significant penalties for non-compliance. Practically, this leads to longer tender processes, as significant clarity as to obligations, liabilities, risk, and criteria for evaluation must be detailed within the ITT, as there is very little scope for amendment once the preferred bidder is determined.

An additional risk, significant to both TO and potential SPV bidder, is the issue of employee transfer pursuant to the Transfer of Undertakings (Protection of Employment) Regulations 2006, as amended by the Collective Redundancies and Transfer of Undertakings (Protection of Employment) (Amendment) Regulations 2014, (collectively known as 'TUPE'). Whilst it is unlikely (though not impossible) that TUPE would apply at the outset of the DA, based on the current legal position, it is highly likely that TUPE would apply to either:

- the transfer of the asset back to the TO (where this was considered to be a *business transfer* pursuant to TUPE), or
- to any service performed by the SPV employees, in pursuance of their operation and maintenance obligations under the DA, which is then arguably transferred back to the TO either at the end of the DA term or upon any earlier transfer back to the TO.

Contractual obligations would be required within the DA to cover the provision of Employee Liability Information and allocation of potential liabilities. It will not be possible to estimate, at the outset, the potential cost this would entail for the TO, and cost recovery mechanisms would be required in the TO's allowances, through consecutive price controls, to cover this unquantifiable risk.

All of the above reinforces the need for primary legislation and that the model as proposed is completely unworkable.

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

As noted above, it appears that Ofgem's proposed role will enable it to control the tendering process, albeit Ofgem has acknowledged that it could not itself run such a tendering process. Ofgem's role creates risks for the TO in terms of the TO's inability to determine an acceptable

risk-allocation in the Delivery Agreement and the appropriate criteria for selecting the winning bidder. In particular, it creates the risk that Ofgem will ensure that a bidder is selected on grounds of price without due consideration as to the risk of non-delivery by that bidder.

The existence of Ofgem's rights of approval also creates risks of delay and uncertainty.

It will be important that Ofgem provides sufficient guidance so that there are no surprises about how it will exercise its powers.

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?

In any SPV model the role of the Independent Technical Advisor (ITA) would be key. They should have a full role in the assessment of design, construction and completion and the ongoing operation of the asset. The ITA could also have a role in the assessment of additional costs or amounts to be provided to the TO because of changes to the DA, providing an independent opinion which Ofgem would be required to take account of in its assessment of any recovery. Recent experience in PFI projects suggests that this should be more than a paper-based audit role. The costs for the performance of this role should be recoverable.

The recent SHEPD New Energy Solution for Shetland (NES) process made use of an Independent Auditor (IA). While distinct from the proposed ITA role, the IA in the NES process tempered Ofgem's ideals and helped to facilitate a reasonable and "market" approach, both for tenderers and, indirectly, for SHEPD and regulatory arrangements. This enabled the development of a more productive relationship between the parties, helping with key decisions and managing unexpected events during the process, such as taking views on reasonable contractual positions referencing both the 'market position and the unique attributes affecting that process and group of islands, and deciding whether to accommodate or prohibit tenderer requests for time extensions etc. The IA helped to hold each party accountable for their own responsibilities.

However, there are questions raised by the ITA proposal in this consultation which require further consideration. The scope of the requirement of the ITA needs to be clearly set out, currently this is noted in the consultation document as '*various functions under the DA*' with a non-exhaustive list of wide-ranging potential roles included. It is unlikely that there is an entity which can perform all these roles and realistically a number of entities will be required. Given the DA will cover the construction period and potentially 25 years of operation, it is unclear how the scope can be clarified with sufficient detail to allow the SPV to cost this into a bid.

There may be issues with the ITA's ability to provide such services where there are potentially more than two parties it reports to. The consultation notes that the ITA could be providing functions to Ofgem and the SPV investors in addition to the TO and SPV itself. It is unclear how this could be managed in practice and clear conflict mitigation measures would be required at the outset.

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

No framework for operational incentives has been proposed by Ofgem. If the asset operated by the SPV is to be ring-fenced from the TO's price-controlled portfolio of assets, then it would be our expectation that Ofgem replicates incentives for the SPV that are in line with the incentives that would be placed on a TO.

Availability incentive

The availability incentive proposed by Agilia suggests that the SPV would be paid if it over-performed, as well as penalised if it underperforms. It is unclear how this would work in practice and how a TO would recover the revenue payable to the SPV if it overperforms.

Incentive to commission

As the TO would retain the obligation to connect its customers in time and face the equivalent penalty if it fails to do so, the SPV should be incentivised in the same way, including a mechanism to allow the TO to recover the penalty from the SPV. Ofgem proposes that a diminished service period for the SPV will be sufficient incentive to commission on time, however it is not clear how any savings which result from this reduced revenue period will be recovered.

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

Our view is that the SPV model based on PF2 principles does not lend itself to potential fluctuation in the final cost as this raises significant obstacles to obtaining project finance style funding.

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

It is unclear what is intended to be achieved by an incentive process that operates during the period of the Delivery Agreement. In the context of a fixed price contract there will be little opportunity to drive savings other than in the context of ongoing operational costs, and it is unclear if all downside risk is being transferred to the SPV why there would be any reason to agree an incentive mechanism.

There is a reference to the TO taking equity in the SPV to incentivise performance. It is unclear how this would assist in this instance. The proposal would be that the TO would be a silent partner and would therefore not be able to influence decision-making. The shareholding would therefore represent a potential dilution of the ability of the SPV's other investors' return. Such an equity interest may also have implications under the ring-fencing provisions in the TOs' licence and the TOs' unbundling certifications.

There is also a proposed alliance model, although this is not clearly defined. Again, it is not clear what the proposed incentivisation arrangements will relate to and how this could operate in the context of risk transfer to the SPV on signature of the Delivery Agreement.

There is also the perverse scenario where the TO would be in the position of an investor faced with taking remedial action against an entity which it part owned and therefore it itself would be liable for part of that cost/loss/repayment. We are aware that a similar equity share proposal may have arisen within the water industry. However, it is unclear how this issue has been resolved either contractually or under licence.

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

Insufficient attention has been paid to the change mechanism that would be needed in the Delivery Agreement. This is critical given the proposed duration of the Delivery Agreement and the likely evolution of the electricity system during that period and the TO's evolving obligations under industry codes and its licence.

Insufficient attention has also been given to what protections the TO needs to include in the Delivery Agreement to enable it to meet its licence and statutory duties.

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?

Fundamentally, we disagree with the proposal that the SPV model will be implemented through an incumbent TO's licence.

As a minimum, we would expect Ofgem to adopt a regulatory framework for the SPV which is in line with the current obligations for existing TOs, whereby the licence obligations are consistent. This would include applying elements such as financial ringfencing, provision of regulatory information, data assurance requirements, and required to maintain investment grade credit rating.

The application of a consistent, robust, and fair regulatory framework should be a priority for Ofgem and is, in our view, a fundamental necessity for any party who builds, operates and maintains transmission assets. The current proposals would have the SPV subject to contractual control only and, in the absence of the regulatory framework, the challenge involved in incorporating the relevant regulatory obligations into a contractual framework is likely to be time consuming, due to the complex and novel nature of the requirements in the UK electricity industry in terms of risk allocation, and not without significant legal cost. We do not consider this to have been given due regard or appropriately assessed by Ofgem. Failure to do so undermines the conclusion that this model is workable and in consumer's interest.

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

transmission network assets are directly regulated by Ofgem. Some of the provisions in the industry codes are fundamental to the workings of the electricity industry and we have provided some further detail in our response to Question 7. Reviewing existing Codes and Standards for their applicability to this new model would be time consuming and not without cost to the industry. Ofgem has assumed, in its consultation document, that there is no requirement for change. Ultimately, this will require industry and the relevant code bodies to review and confirm. If changes are required, it is unclear where this fits into the proposed timeline for the SPV model and current project pipeline with contracted dates for connection. It also begs the question as to whether the impact (cost and time) of making these changes is appropriate when compared with what is expected to be required for the delayed but forthcoming Competitively Appointed Transmission Owner (CATO) regime.

Whilst Ofgem discusses a set of draft illustrative licence conditions in its consultation, it has only provided a draft of the proposed new special licence condition 6M/J, and has given no indication as to what changes may be needed to other special conditions; nor has it discussed any detail around a new financial model (and handbook/guidance) that will be required if the current Price Control Financial Model (PCFM) is not modified.

Ofgem has stated that it does not believe changes are required to the ESO licence, to the TO standard licence conditions or to industry codes, although it is consulting on any 'beneficial changes that could be made in any of these areas'. Ofgem must consider whether both the Connection and Use of System Code (CUSC) and the System Operator / Transmission Owner Code (STC) may require amendments to accommodate the new regulatory model and a review of both, by their respective governance bodies, is recommended.

In addition, it is not clear how the SO will recover the 6M/J Construction period allowance and operational period allowance and pay this to the relevant TO. If the revenue recovery is to be via a new financial model, this needs to be developed, consulted on and delivered in parallel with the SPV timeframe. The whole process of SPV revenue recovery needs to be clarified as a matter of urgency.

TO risk

We are concerned with the level of risk that must be borne by the TO due to the proposed interactions between the commercial framework and regulatory framework.

For example, only once the SPV has been appointed, and therefore the Delivery Agreement entered, will Ofgem consider whether to approve any changes to the TO's allowed revenue recovery through its licence. We also note that whilst the recommendation of the ITA will be taken into account by Ofgem, it will be in no way binding. Ofgem states that any delay between the Delivery Agreement being entered into and regulatory approval being given, should not prevent the SPV from commencing works or being paid by the TO where required under the Delivery Agreement. Similarly, Ofgem's approval of any cost adjustment or revenue change in the TO's licence will be a separate decision to the adjustment to the SPV's costs by the TO under the Delivery Agreement. There must be alignment between the decisions made and approved by the ITA under the terms of the Delivery Agreement, and those made by Ofgem.

The TO also bears licence enforcement risk and is unlikely to have commensurate rights of recovery under the Delivery Agreement which is not acceptable.

Step-in rights

Ofgem and Agilia propose that the TO will have step-in rights, the terms of which will be included in the Delivery Agreement with the SPV. We think it is important that any step-in rights are specified in the TO's licence.

Draft illustrative licence conditions

We have not commented on the detail of the draft licence conditions presented in Appendix 1 of the consultation as we understand this will be covered through the licence drafting workshops Ofgem has organised for November and December. For the avoidance of doubt we do not support licence changes for the reasons expressed throughout this response.

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

Given that Ofgem proposes to include much of the detail of these obligations in its Delivery Agreement Guidance and Procurement Guidance, it is difficult to comment at this stage on the reasonableness of the obligations which may remain with the TO. However, we provide some initial observations based on the information provided.

Ofgem needs to clarify what it means by "relevant" pre-construction activities, and where TO responsibility ends for the project and SPV responsibility begins. A TO should not be penalised for not 'efficiently supporting' eventual delivery of the SPV model, if the expectations are not clearly specified.

We note that Ofgem expects the TO to continue to undertake pre-construction activities simultaneously, whilst developing the Delivery Agreement and relevant tender documentation for the SPV tender. Ofgem should consider whether the TOs will be suitably resourced to carry out both duties and what impact these additional responsibilities will have on the TOs business as usual activities.

Placing an obligation on the TO to make the SPV model work whilst still ensuring deliverability of the project seems unreasonable. Before proposing the SPV model for any project, Ofgem must undertake due diligence to ensure that competition is appropriate and there is no risk to deliverability of the project, as per its intention "*As part of our decision to use the SPV delivery model for a particular project, we will take into account the deliverability of the project in the context of running an SPV tender*". Ofgem must engage closely with the incumbent TO as part of the Needs Case process to adequately inform its decision.

We are concerned with the proposal that the TO may be obliged to run the tender in the absence of a full suite of DA documentation. This puts the TO and SPV bidder at risk and will presumably result in inflated bids due to bidder uncertainty.

We are concerned with the proposal that, if a SPV tender fails, a further tender exercise will be required. Ofgem should reassess project deliverability against TO contractual connection commitments in the event of tender failure, to determine whether a new tender is the appropriate and proportionate approach for that project. Consideration of the impact of tender failure on market appetite would also be required. It is also not clear what Ofgem proposes to do if response to pre-tender marketing is minimal/zero or does not meet the requirements of the request. In the event that a tender fails, Ofgem should revert to the existing Strategic Wider Works (SWW) uncertainty mechanism. In order to do this, it is important that Ofgem continues to undertake the Project Assessment phase of the SWW process concurrently with any obligation it may place upon a TO to run a SPV tender for a particular project.

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

The approach increases the prospect of the risk of a mismatch between the TO's allowances and the TO's payment obligations under the Delivery Agreement.

No provision appears to have been made to compensate the TO for the risks it bears and role it undertakes, beyond cost recovery. As set out in the above sections, the allocation of risk and liabilities is unclear and places a significant degree of responsibility and obligation on the incumbent TO. As a result, shareholders and investors would not expect to take on additional risks without being adequately compensated for any subsequent impact on its own financial arrangements, for example to cover any additional cost of risk (i.e. any impact to gearing and cost of borrowing). This has clearly been overlooked by Ofgem to date.

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

We refer Ofgem to our response to Question 4 in the 'Commercial framework' section for comments on the operational period incentives proposed and how these interact with the TO's licence and price control incentives.

Fundamentally, it is important that the SPV's incentives are inextricably linked to the TO's incentives. This is also related to the regulatory obligations placed on a TO and how these are 'backed-off' under the DA to the SPV.

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

In the development of the RIIO price control, Ofgem reconsidered the appropriate level of 'asset lives' for the purpose of calculating depreciation and after a prolonged consultation period Ofgem opted to follow a 45-year asset life for RIIO-T1 and RIIO-ED1. By opting for a 25-

year asset life, Ofgem is accelerating the charges to current consumers to the benefit of future consumers assuming the asset will not need to be replaced shortly after the 25 year period has expired.

We have previously raised our concerns[17] that a 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 at the end of the SPV's revenue term, but the TO may yet have to fund the operation and maintenance of the asset for up to another 15 years (or even more). Based on the information that has been published, Ofgem has still not clarified how this additional cost to the TO is to be funded, such that customers do not face being over-charged for assets. We urge Ofgem again to clarify this point.

We are concerned that the unintended consequences of a 25-year contract term with an SPV may result in poorly maintained assets being transferred to the TO along with the operational risk. We believe that the risk management of these assets on behalf of customers is critical to mitigate poorly managed assets being transferred to TO's. 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. If, as Ofgem proposes, these assets have zero regulatory value after the 25-year contract term, then 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.

Ofgem has noted previously in relation to CATO, that some form of guarantee would be required to ensure customers were compensated for poorly maintained assets. This has not been proposed for the SPV model. Ofgem needs to consider the cost to customers that may arise because 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. As suggested previously, 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.

Locational and Residual charging

We believe that a 25-year recovery period would automatically result in a higher Maximum Allowed Revenue (MAR), and therefore more expensive TNUoS charges over the 25-year term. This raises issues of inter-generational equity and whether Ofgem has appropriately balanced the interests of current and future consumers, given the mismatch between the return period and the likely operational life of the assets.

Price signals (locational charges) to generators have historically been based on the life of an asset (i.e. the 'real' cost of the asset), not the revenue period for an SPV, unless Ofgem is proposing that these assets will have a reduced lifespan? We cannot see how this will not be

[17] SHE-T responses to 30th August 2017 'Hinkley-Seabank – Consultation on Final Needs Case and potential delivery models' and 23rd January 2018 'Hinkley-Seabank project: minded-to consultation on delivery model'

to the detriment of customers connecting (e.g. generators) who will pay for the full cost of the asset over the 25-year period. In addition, how does Ofgem propose to address situations where changes to SPV assets and therefore changes to the MAR are required? This is not a risk which needs to be considered by OFTOs, which are built to connect a specific offshore development for their 25-year revenue period. As set out earlier in our response, it is unlikely that an SPV asset will remain unaffected over a 25-year period.

We think it is important for Ofgem to clearly set out how it proposes to enable the recovery of the cost of the asset so that the potential impact on connecting customers and consumers can be better understood.

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?

Given that Ofgem's driver behind the SPV model is to create additional cost efficiencies through the use of competition, it is difficult to understand why the incumbent TO would be excluded from bidding. If the incumbent TO can offer the most cost effective and efficient solution, it should be allowed to deliver the asset. We noted, with concern, Ofgem's proposal at its 29th October SPV stakeholder event, that even if the SPV tender results in higher cost solution, Ofgem would not default back to the TO to deliver the asset under the SWW mechanism. We do not understand the rationale for this and why Ofgem would allow the GB consumer to pay more when a demonstrably cheaper solution is available with significantly less risk.

The conflict mitigation proposals proposed, as noted by Ofgem, go beyond those proposed for CATO, and we believe it would be difficult for these to be implemented in time for projects that are already at a final needs case stage.

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

We believe that the SPV should be party to the industry codes and standards that apply to any operator of an onshore transmission asset. Based on the proposal presented, it is unclear how the relationship between the ESO, TO and SPV will work in practice.

Engagement is required with the ESO to understand these interactions and whether any changes to the ESO's licence would be required.

We would be surprised if changes are not required to the CUSC to recover the revenue for the SPV asset over the 25-year term.

There will need to be a thorough review of the industry codes to understand what changes are needed and we cannot understand how Ofgem has concluded that there is unlikely to be a

need for change. Some of the provisions in the industry codes are fundamental to the workings of the electricity industry and we provide two examples to illustrate this:

1. There are provisions in the CUSC (and standard form connection agreements appended thereto) that restrict the ability of CUSC parties to bring tortious claims against transmission licensees. An SPV will not have the benefit of these provisions and therefore will be exposed to huge potential liabilities to users of its system. We would expect there to be a desire to amend these provisions to enable a SPV to rely on them to facilitate project finance. In any event, we would expect the issue of whether such an amendment would be necessary or desirable to be considered.
2. There are also provisions in the STC that regulate the process for a TO to respond to a request by the ESO for a connection offer. These provisions will need to be considered carefully in light of the SPV's role in respect of connections on its system.

PROCUREMENT PRINCIPLES

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

There has been very little meaningful detail provided. SSEN considers there are several issues with the Ofgem proposals as set out in more detail below.

Project Pipeline

There is currently no clarity of a long-term pipeline of projects, beyond those currently proposed for T1 and early T2 through the Network Options Assessment (NOA). If there is no clear pipeline of projects, this is unlikely to attract new market entrants as the cost of setting up an entity and preparation of bids in this highly technical and specialised industry is likely to be costly. Ofgem offers no recovery of sunk costs to unsuccessful bidders.

Value for Money

It is difficult to see how, based on the current information, the SPV will deliver value for money to the consumer for a variety of reasons. Value brought by the TO under the current and proposed RIIO framework and licence arrangements is unlikely to be replicated under the terms of the DA. In addition to regulatory oversight and transparency on costs, the regulatory framework provides mechanisms, via the licence, which require a TO to build, operate and maintain its network whilst developing and promoting, amongst other things; innovation, enhanced environmental, sustainability and efficiency policies across its operation, protection for vulnerable customers, significant stakeholder engagement and consultation, and engaging with contractors local to the project site. There is no analysis on the potential wider negative impacts of a SPV delivering a project in a particular area.

Fixed Price

Fixed Price, both at early design stage and late stage tender processes, is likely to result in the SPV significantly inflating a tendered price to meet any requirement to be 'fixed' whilst seeking

to counter the potential for significant additional cost due to unforeseen risk and change in design/legislation/regulatory framework over the term of the DA.

Supply Chain

The supply chain inevitably will be quite similar. As a prudent operator, SSEN engages with a number of contractors who can deliver (companies which have met strict qualification criteria of delivery on comparable projects, minimum financial standing requirements, and technical capability etc.). If the same companies are likely to participate in this process, taking on an increased level of risk, it is unclear why both Ofgem and Agilia consider this would result in reduced costs or any other benefit to the consumer. Neither the Impact Assessment nor the Agilia report provides any analysis on the current or potential supply chain.

The opposite effect could be the reality. With the potential of large projects no longer being within the visible pipeline for the TOs, the benefit of being able to attract contractors with longer term visibility/continuity of work, achievable under existing longer-term framework arrangements, would likely be lost. This model could potentially increase costs both for SPV and remaining TO projects.

Innovation through procurement

In some areas of transmission asset construction, there are currently a limited number of market participants, sub-sea cable for example. It is unlikely that there will be new market entrants able to provide confidence in their ability to deliver, and develop and innovate, at least in the short to medium term, if at all. Whilst some level of innovation may be possible in the smaller scale, on technically simpler assets, it is unlikely that there will be any new market penetration at the technically complex and highly expensive end of the spectrum. This calls into question the potential 'savings' available through the SPV model on this type of project.

Reduction of synergies

The proposed SPV model, if implemented, could result in a number of different and separate SPV entities (designing, building, financing, operating and maintaining different projects across the UK Transmission Network) participating in the GB Transmission Network. this will inevitably require separate operations teams and maintenance arrangements, in addition to those of the TO. Ultimately, the consumer will bear the additional cost of the loss of shared synergies provided under the current TO arrangements.

We strongly urge Ofgem to undertake further analysis to determine whether there is any market appetite to enter into such an arrangement based on the legitimate risks outlined in this and our previous response. It would not be proportionate for Ofgem to proceed with the SPV model before carrying out such analysis, given the importance of understanding whether the alleged benefits of the SPV model are realisable.

Liability/TO Returns

Given the novel and complex nature of the current proposal, SSEN would welcome Ofgem and Agilia's thoughts as to how any deficiencies in the initial tender processes will be approached.

It is likely, even in the most '*efficient*', considered and properly conducted tender exercise, that there will be unintended gaps, both within the process itself, and in the tender documentation and DA, with resulting unintended consequences and liabilities. The TOs have not conducted any such tender exercise or developed and operated any part of their networks under the terms of a DA previously. The consultation makes it clear that the TO recovers only its costs (which may be limited to a percentage of the value of the project) of the procurement. The SPV will have an ability to reasonably request additional sums in such unforeseen events, yet the TO's recovery of any unforeseen cost or liability will be subject to the discretion of Ofgem.

Potentially there is a significant liability for the TO if they are still designated as the asset owner. Key areas which require Ofgem's further consideration are:

- Keeping the lights on and the TO's statutory and licence duties (and inability to transfer the associated risks to the SPV through the DA and/or inability to recover from the SPV in the event of insolvency)
- Risk of not recovering allowances despite obligation to pay SPV under the DA
- Risk of contractual liability (via the ESO) for late delivery (Liquidated Damages)
- Changes to requirements and/or specifications set out in the original tender, and/or additional requirements from Ofgem during the tender process resulting in amendments to the original tender
- Post contract changes due to overall system upgrades etc.

If TOs remain liable for these issues, cost recovery and other mechanisms will be required to manage these risks (which could be significant).

Timescales/Price certainty

In theory, a 12 to 15-month period for conducting a regulated procurement may be possible, provided that the DA and ITT documentation, and data room, is prepared and approved in advance. The reality may be very different. From the point a TO issues an ITT, potential SPV bidders would have to prepare work packages, issue their own tenders (ensuring any bid validity covers the period of the SPV tender and Ofgem approval process), conduct tender negotiations in respect of their own procurement processes concurrently with the TO SPV process etc, and encapsulate this within bid proposals. The time required to undertake this task with any degree of certainty on risk and price would exceed the timescale Ofgem has proposed. If held to the proposed timescales, it is likely that bidders will need to take a view on potential risk quickly, resulting in over-inflated risk contingency.

Practical Issues

There are several practical issues and impacts that need to be considered:

- *Ongoing work* – typically projects are dynamic and will require ongoing work by the TO when the tender to the SPVs are being issued. How will this be managed in the proposed process (Planning applications/public consultations etc)?

- *Local contractors/impacts to community* – there is the potential that the SPV will engage with national/international contractors as consortium/JV arrangements (as they would be the only companies who can finance the SPV scheme) or through its own procurement processes. This could limit opportunities for the local supply chain, something which SSEN has promoted through its own processes. Will there be a requirement on the SPV to facilitate the same local engagement in construction/operation and maintenance works?
- *Post contract changes in specifications/system security requirements* – if, post-delivery, a TO is required to amend its standard asset specifications because of legislative/regulatory/industry standards, which in turn requires changes to the SPV asset, this will require clear protocols and provisions in the DA to manage this process and facilitate changes to allowances.

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?

Both this and our response to question 1 clearly sets out our concerns, each with potentially significant impacts, arising out of the current proposals.

Ofgem is keen to portray this as a simple process, despite the significant concerns raised, not only by the TOs but also other interested parties, potential bidders and investors, and we urge it to seriously reconsider the foreseeable and unintended consequences of its ill-defined proposal.

Further detail is required in respect of the allocation of responsibilities between the TO and SPV. This is fundamental to the drafting of the DA, particularly in respect of allocation of risk, incentive and enforcement mechanisms. The TOs will need the ability to back off licence requirements through contractual obligations, with considerable change mechanisms to deal with any change in licence requirements/design changes/new reinforcements over the term of the DA. This will not make the DA low risk in the eye of a potential bidder or investor, particularly given that many of these risks will be unquantifiable at the point of bidding.

There are complex provisions which would be required to deal with a SPV's failure to comply with its obligations under the DA, poor performance or insolvency. There will be conflicting interests between those of the TO, trying to maintain the service and 'keep the lights on', and those of the investors who will be seeking to mitigate their financial exposure, all of which needs to be negotiated and drafted effectively.

Similarly, significant consideration should be given to the conditions and mechanisms required to facilitate handback at the end of the DA term, including incentives and/or enforcement mechanisms for failure to comply. We would welcome Ofgem and Agilia's thoughts on how it proposes to deal with this. For example:

- Will there be a minimum schedule of condition?
- Who would assess this?

- What would the dispute process look like?
- Will there be continuing obligations for the SPV, preventing it from winding up on expiry of the term to avoid any claims for failure to comply with handback obligations (which may or may not be immediately apparent)?

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

Until the full detail of the proposal is provided, including the Delivery Agreement Guidance and Procurement Guidance, an assessment of what is or is not appropriate cannot be made.