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Orkney transmission project: Consultation on Final Needs Case and Delivery Model

Dear James,

We note that the Competition Proxy Model proposed for Orkney is almost identical to that proposed for NGET's Hinkley-Seabank project. As such, our position remains the same as that set out in our response to the previous Hinkley Seabank consultations: we believe that this model would not deliver consumer benefit but could in fact cause a consumer detriment. As such, we do not support its application.

The model proposed does not reflect the outcome of competition. As we noted in the context of Hinkley-Seabank, the methodology used to develop the cost of capital range references a set of benchmarks which are not comparable to the construction and operation of the Orkney transmission assets, the methodology contains material inconsistencies, and the uncertainty around multiple aspects of the model would not be acceptable to investors.

Ofgem's consumer benefit analysis contains multiple flaws and omissions. For example, any analysis of the net consumer benefit should also take into account the costs associated with transferring risk away from the project in order to facilitate a lower cost of capital. As the quoted net consumer benefit associated with using the Competition Proxy Model is already small, it is likely that a robust consumer benefit analysis which factors in these costs as well as using a more realistic set of benchmarks would not show a net benefit.

We are also concerned by the impact on investor perceptions of introducing a new regulatory model part way through a price control. If investors were to perceive the regulatory regime as less stable, they would require a higher cost of capital in order to be willing to invest. Higher cost of capital allowances in future price controls would ultimately result in increased costs for consumers, which would significantly outweigh any consumer benefit which would result from the introduction of the Competition Proxy Model. As the Competition Proxy Model does not involve a competition, it cannot be expected to deliver the benefits typically associated with competition, such as technical or price innovation.

In consideration of Ofgem's principal objective of protecting the interests of consumers, it is difficult to see how it could pursue the Competition Proxy Model, and therefore should revert to using the proven Strategic Wider Works delivery model, which allows for regular price controls to set TO revenues in line with market conditions.

Yours sincerely,

[By email]

Chris Bennett

Director, UK Regulation, National Grid

Responses to specific questions

Question 1: Do you agree that the current network on Orkney needs reinforcing in order to connect additional generation?

As the 75MW of renewable generation already connected on Orkney is currently heavily constrained, it seems logical to reinforce the current network if additional generation is to be connected.

Question 2: What are your views on the generation scenarios developed by SHE-T? We are particularly interested in views on the likelihood of wind generation progressing without subsidy support and the likelihood of tidal generation around Orkney developing to the levels predicted by SHE-T's scenarios.

As Transmission Owner in England and Wales, we are not well placed to comment on SHE-T's generation scenarios. However, we would highlight that uncertainty regarding the delivery model to be used for subsea links such as Orkney means that generators would not have clarity regarding their transmission charges, or the party which will deliver their connection. This uncertainty, alongside the proposed industry charging reviews and the lack of a confirmed route to market, may discourage new generation projects from coming forward.

Question 3: What are your views on the technical design and costs of the proposed Orkney link?

Whilst we do not wish to comment on the appropriateness of SHE-T's design, in general we believe that the developing company (TO) is well placed to choose between the different options as the need for the project becomes clear. This should be recognised, and supported by incentives that reward the delivery of efficient connection solutions.

Question 4: Do you agree with our concerns that a constraints-based CBA may not robustly demonstrate the true consumer cost/benefit of a radial extension to the transmission network?

We note that many generation projects may not be willing to undertake commitments until Ofgem has confirmed that a subsea cable will be built. However, we note that the costs of onshore wind generation are falling rapidly, and Orkney has the natural geographical resources to allow for significant wind generation. As such, it would seem that committing to construct the cable would allow for renewable generation projects to come forward, and decrease the overall costs paid by consumers.

Question 5: What are your views on the 'additional CBA', outlined in this chapter, which has been used to sense check the results of the original constraints-based CBA?

The consultation does not provide much detail about the 'additional CBA' and, as such, NGET is not able to comment on this.

Question 6: What are your views on our proposed conditions of approval? Specifically:

- 1. Do you agree with our view that the information available does not demonstrate that building a 220MW connection to Orkney would be beneficial for GB consumers if only 70MW of generation came forward to use the link? Do you agree with our proposal to set a minimum-generation threshold of 135MW?**
- 2. Do you agree that the fact of a generator signing up to SHE-T's 'Alternative Approach' does not provide an adequate level of certainty that the generator will progress to full commissioning?**
- 3. Do you agree that the award of a CfD to a generator would provide an adequate level of certainty that the generator will progress to full commissioning?**
- 4. Do you agree that, in the absence of a CfD, a generator securing planning consent and finance to construct a project is a good indicator of a project's likelihood of progressing to commissioning?**

5. If you answered no to questions (iii) and (iv) above, can you propose any alternative ways to assess, to an adequate level of certainty, whether a generation project will progress to commissioning?

We are not well placed to comment on the proposed Alternative Approach. However, we note that the extent of uncertainty regarding the need for and size of the Orkney cable, and the manner in which this would be determined, makes it unlikely that the project would be financeable, because investors would not be willing to spend time and resources on preparing a bid if there may not even be a project to bid for. As such, the Orkney project would be unlikely to obtain Project Finance, and it is not expected that a third party would be willing to compete to deliver and operate it, particularly at the low cost of capital proposed.

Question 7: Do you agree with our assessment of the Orkney project against the criteria for competition?

We agree that the Orkney project meets the new, high value and separable criteria.

Question 8: Do you agree with our proposal not to competitively tender the Orkney project using the SPV model or under our CATO framework unless there are significant delays to the delivery timelines?

We agree that the current timescales do not allow for the Orkney project to be competitively tendered. Even if the timescales for the Orkney project were to be delayed, it would introduce considerable uncertainty if Ofgem were to revisit its decision on the delivery model. Committing to a delivery model sooner rather than later would allow SHE-T to progress the project, without the additional risk that it might have to be transferred to a third party at a later date.

According to Ofgem's publications, it would take 12-15 months¹ to appoint an SPV, and 18-24 months² to appoint a CATO. We note that the Orkney project is due to start construction in 2020, and be complete by October 2022, and there is not yet sufficient certainty regarding the volume of generation due to connect on Orkney and therefore the required capacity of the link. By the time the need for the project is sufficiently certain, there would not be time to run a tender to appoint a third party to deliver the project. Running a competition while generation levels are still highly uncertain may result in wasted tender costs, and would not be in the consumer interest.

We note that the SPV model is not yet sufficiently developed to allow for it to be implemented in the near term, and responses to the September 2018 consultation point to a number of areas which require further consideration. Notably, it is not clear that the SPV model would deliver a consumer benefit, or that an SPV would be able to operate transmission assets without a licence.

Question 9: Do you agree that the Competition Proxy Model would deliver a favourable outcome for consumers relative to the existing SWW delivery arrangements?

Based on the information published by Ofgem, we do not agree that using the Competition Proxy Model for Orkney would deliver a consumer benefit, although we note that a project-specific Impact Assessment has not been published. Our concerns in relation to the Competition Proxy Model, are referenced in our March 2018 response to the Hinkley-Seabank delivery model consultation.

The Competition Proxy Model sets a revenue stream which cannot and does not replicate or represent the result of a competition. It contains multiple errors and inconsistencies, and is not yet fully developed. It relies on a cherry-picked selection of benchmarks that are not comparable to the Orkney Transmission project. The reliance on these inappropriate and selectively used benchmarks results in an artificially low cost of capital, which does not account for the required transfer of risk and the consequential increase in capital costs.

¹ https://www.ofgem.gov.uk/system/files/docs/2018/10/spv_consultation_2018_final.pdf

² https://www.ofgem.gov.uk/system/files/docs/2016/11/quick_guide_to_cato_-_nov_16.pdf

Ofgem claims that three sources of value would result from the Competition Proxy model: capturing what is described as a 'historically low' cost of debt, using higher gearing than elsewhere in the RIIO price control, and locking in a low operational rate of return. We do not believe that any of these sources of value can be realised in practice. Capturing a low cost of debt relies on Ofgem's ability to forecast the cost of debt, realising value from high gearing contradicts the established corporate finance principle that firms cannot lower their cost of capital by simply increasing leverage (the Modigliani-Miller theorem), and the principle of capturing low operational rates of return does not account for the differences between the OFTO and Competition Proxy regimes. We also note that it is unlikely that a standalone company delivering this project would be able to access A-rated debt during the construction phase, particularly as revenues do not begin until the operational phase.

Ofgem gives two ranges of consumer savings associated with using the CPM for Orkney: £12-£25m, and £-1m-£41m. It is not clear which combinations of scenarios result in which consumer savings. However, we note that the December 2018 RIIO-2 sector-specific methodology³ proposes a cost of equity at the bottom of the range previously quoted: this implies that consumers would benefit less from the introduction of an alternative model than originally anticipated. We note that Ofgem has not published an Impact Assessment specific to the use of the CPM for Orkney. As such, we cannot comment on that Impact Assessment. However, based on the data we have seen to date, we would not expect there to be any consumer benefit once the updated RIIO-2 parameters are taken into account, and the figures from the July 2018 CEPA report which feed into the CPM are updated (a cut-off of September 2017 is currently applied).

We note that the Competition Proxy model is not consistent with the RIIO-T1 Final Proposals, which set out that Strategic Wider Works projects such as Orkney could either be delivered by the incumbent TO, at the RIIO cost of capital, or a competitively appointed third party TO. The introduction of any new delivery models should be considered holistically as part of the RIIO-2 price control: introducing alternative models part way through a price control would impact on regulatory stability and investor confidence.

It would therefore be unjustified for Ofgem to depart from the proven Strategic Wider Works delivery model, which allows for regular price controls to set TO revenues in line with market conditions.

Question 10: What are your views on the way in which we have applied project specific updates to the Competition Proxy Model methodology to account for the specific characteristics of the Orkney project?

As part of its update to the Competition Proxy model, Ofgem should update the cost of debt figures to use expected rates at the time that the cost of debt would be locked in, as the figures used at the moment are based on September 2017 rates. This would give a more realistic indication of the cost of debt figures which would be locked in by the model.

The proposed model does not provide a revenue stream during construction. Responses to the September 2018 SPV consultation suggest that this would be less attractive to investors, and could result in an increase in the required cost of capital.

Ofgem proposes to adjust the construction equity beta to reflect the risks of subsea working. However, this is based on the figure Ofgem has itself set for OFTO build, which has not been applied to any projects in practice. This cannot be described as a figure which uses a competitive benchmark.

³ https://www.ofgem.gov.uk/system/files/docs/2019/01/riio-2_sector_methodology_0.pdf