MORGAN SINDALL INFRASTRUCTURE

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Ofgem
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Dear Sir / Madam,

Further to Ofgem's consultation request for the RIIO: T2 Methodology in the Electricity Transmission market, Morgan Sindall would like Ofgem to consider our assessment outlined below:

We consider that the sharp reduction of WACC by over 60% to 2.64% is too low to gain the interest of investors on the following basis:

- Traditional SPV's that bid projects of this nature are made up of contractors and private equity providers both of whom contribute equity. The SPV's equity return that both of these entities would ordinarily expect would attract double digits even in this era of low base rates. This reflects the internal company WACC, cost to bid, win/loss ratio, returns on competing projects and the construction and operational risks. If the returns were at the levels quoted the construction equity investors would not invest equity when the project WACC was below what it cost to borrow the money internally.
  The only way to achieve this low level of equity returns would be to increase the construction price which would result in a less competitive price and become self-defeating.
  Construction industry WACC is in the region of 6-9% at present and we would expect to make a return above this, commensurate with the risk taken when investing in complex transmission projects. There is a further risk that the constructor may misunderstand the risks or choose to compromise on safety and quality to achieve a cheaper construction price.

- The Thames Tideway model has an expectation of lower investor return and lower capital costs but this is only achieved by additional financial support provided by a guarantor (Government) and the risks being pushed down to the building contractor. The pushing down of risks to the Contractor will only result in a higher construction price so, as above any saving in the capital cost is counterbalanced by an increase in construction price. The current experience of contractors on Thames Tideway would suggest that any future projects bid on this model would have much higher construction prices to reflect the risk profile being pushed away from the investors.

- If WACC at this level became the norm it will not promote sustainable investment in the energy industry:

  - To have the expected WACC at these levels makes the underlying assumption there is limited risk associated with these projects and an excess of funds available for investment. As soon as one of the projects fails or has issues that affect the equity returns the investors will realise they have mispriced the investment and future investment will be adjusted to reflect this. These issues could include contractor collapse and operational problems; particularly post defects liability period, mispriced lifecycle, political / legislative change risk etc. Should any contractors invest equity and the project not go well, it will have a negative impact on the likelihood of bidding and investing in similar projects in the future in the event of a pipeline of work.

  - The anticipated low-level margins will also limit the amount of money funds are prepared to invest in sectors such as this. If there are a number of these projects coming out, the pipeline of projects needs to be sustainable and provide a competition for all the projects bought to the market. This applies to both equity / funders as well as contractors.

  - From an equity and senior funder point of view all projects have an element of risk during the construction period; namely contractor stability, delayed completion etc. This is also extended through operation performance via below expectation, mispriced lifecycle and operational costs, legislative change risk etc. The likelihood such risks is traditionally priced within the contractors' margin and, with such a low WACC we believe it would make such projects unattractive to the market.

  - To be clear Morgan Sindall would not look to be an equity investor with the current level of proposed WACC.

  - Counter to Ofgem's assertions, projects of this nature do bear considerable risk during construction as is being experienced on Thames Tideway. In fact, with such pressure applied to the returns, this risk will need to be fed in to the construction costs, assuming a contractor would be comfortable with this level of exposure. This means that the initial capital costs for delivery are likely to be significantly more than current proposals where there is a more pragmatic approach to risk taken by NGET and other incumbent TO's like SHET. In our view the Ofgem proposals will see these incumbents attempt to pass on additional, inappropriate risks to the contractors which will in essence reduce competition and increase initial capital costs for schemes tendered.

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- Ofgem appear to be suggesting that there could now be three routes for competitive award to build a transmission asset:
    - CATO
    - SPV
    - CPM

  Having multiple vehicles has the potential to create further delays in delivering a sustainable pipeline of works within the sector. It also means that both equity and construction partners may fail to ramp up the resources to ensure a competitive bidding process particularly if the returns are seen as low.

- In addition, the above was also discussed at the SPV stakeholder event on the 29th October. If Ofgem is to progress in the above manner then it will be important for them to identify a pipeline of projects that are proposed to follow any of the prescribed routes. It should be noted however that, given the size of these schemes as outlined above the number of organisations able or willing to finance them is likely to reduce as awards are made. This will in turn again lead to reduced competition.

We are also concerned about resource retention and development within the Energy Sector:

- The UK transmission industry is already facing a challenge in terms of resource development. Specialist skills in project management, engineering, jointing, fitting and OHL resources require a steady pipeline of opportunities to enable UK contractors to develop the skills required at this level that could be required now and even more so pending our exit from the EU. Add to the mix other competing infrastructure projects then low returns in this area will mean a significant reduction in capacity.

- The TO's need to be able to provide the market with a sustainable pipeline of projects; the separation of the high value projects will in our view have a negative impact on their ability to support the supply chain.

- If there is not a sustainable work book for the contracting community then it is likely we will see further consolidation and withdrawal by contractors within the market. This means there will be reduced competition, increased delivery costs and a lack of long term investment in skills.

Looking at the overall savings predicted by Ofgem's assessment; between 4-10%, on a project in excess of £100m. Whilst the headline number appears to generate a significant potential saving, when taken over the 25-year life span of the assets and spread amongst the UK's approximately 27million consumers it effectively delivers a small gain for the UK consumer. If this was offset against the risk of a skills shortage, the need for greater returns based on the level of risk and anticipated higher construction costs, then this dilutes further.

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To be clear our view is that the current proposals are too short term focused. We would therefore suggest further consultation is required to ensure the industry is able to achieve a level of sustainable investment for the longer term.

Therefore, taking the above in to account we would suggest the following would generate a greater level of efficiency within the market:

- Encouragement of the wider use of P13 principles[1] across capital projects in the sector. Setting up projects in an enterprise environment to create 'lean' project delivery structures with clear outcomes and shared incentivisation for maximising the long-term benefits to consumers and stakeholders. These principles are already being successfully applied by organisations such as Highways England, Environment Agency, London Underground, Anglian Water, Yorkshire Water and Heathrow.

- The TO's and their supply chain partners should also be incentivised for out performance against the NOM's or construction target cost. A percentage of this should be utilised by the industry to encourage skills development both within the TO's and their respective supply chains. This could for example be in the form of a social value bank which is used to support investment within the communities' projects are delivered within. Morgan Sindall are the leader on the Carers in Cumbria SVB for work within the nuclear industry which is proving to be very successful.

If would like to discuss our response further, then please do not hesitate to contact me on the details show below.

Yours Sincerely

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[1] *Project 13 Enterprise – Ref: The Infrastructure Client Group – http://www.p13.org.uk/ The ICG includes a number of clients from across the regulated sector. There are a number of water companies that have successfully come together and are demonstrating a number of P13 Principles who's outcomes are aligned to regulatory outcomes.*