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30th May 2019

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

Dear James,

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

The model proposed does not proxy the outcome of competition. As we noted in the context of Hinkley-Seabank and Orkney, 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 Shetland transmission assets, the methodology contains material inconsistencies, and there is still considerable uncertainty around multiple material aspects of the model which would not be acceptable to investors. Such uncertainty continues to persist and some aspects of the model will not be known until after construction is complete.

Ofgem's consumer benefit analysis contains multiple flaws and omissions. For example, any analysis of the net consumer benefit should also fully take account of the costs associated with transferring risk away from the project in order to facilitate the lower cost of capital range which is based on project finance benchmarks, where such risk transfers are standard practice. Ofgem also uses out-of-date market data despite its assertion that updated parameters would be available shortly after the publication of the minded-to position. As the quoted net consumer benefit associated with using the Competition Proxy Model for Shetland is already small, it is likely that a robust consumer benefit analysis which uses the correct market data, and factors in the costs of risk transfer 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 could result from the introduction of the Competition Proxy Model. As the Competition Proxy Model does not involve actual competition, it cannot be expected to deliver the benefits typically associated with competition, such as technical or price innovation.

In light of the above we fail to see how pursuing the Competition Proxy model is consistent with Ofgem's principal objective of protecting the interests of current and future consumers. We would therefore repeat the view expressed in our Hinkley-Seabank and Orkney responses, that Ofgem should revert to using the existing and 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]

Richard Allman
Head of Hinkley Finance, UK Regulation, National Grid

Responses to specific questions

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

As the current network on the Shetland Isles is unable to accommodate any new generation, we agree that the current network would need to be reinforced 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 on the Shetland 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 Shetland 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.

However, we note that the costs of onshore wind generation are falling rapidly, and the Shetland Isles have 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 3: What are your views on SHE-T's approach to optioneering, are there other options that SHE-T could have considered?

It seems that SHE-T has considered a wide range of options, as it considered twelve link options across three geographical corridors.

Question 4: What are your views on the CBA put forward by the ESO?

We are not well placed to comment on the ESO's CBA, but note that the ESO has followed a methodology consistent with that used on previous Strategic Wider Works projects and in the NOA. Table 4 shows that the 600MW option is clearly the option which has the least worst regret.

We note that there is potential for SHEPD, on behalf of demand consumers, to contribute to the costs of transmission links to reflect the avoided cost of securing demand on Shetland once Lerwick Power Station closes. It would seem logical for Ofgem to factor this into its assessment of the CBA of building the Shetland transmission link, rather than assessing it separately.

Question 5: What are your views on the technical design and costs of the proposed Shetland 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. We also note that SHE-T has progressed development in order to meet the deadline imposed by the closure of Lerwick Power Station, as late delivery would be detrimental to consumers.

We have not been provided with sufficient information to determine whether SHE-T's capital costs are reasonable. However, we note that Ofgem is proposing not to fund a significant proportion of SHE-T's submitted costs, which could negatively impact on investor confidence in Ofgem's competitive delivery models. The Project Assessment is the right place to undertake a thorough assessment of the incurred costs.

Question 6: What are your views on our minded-to position to conditionally approve the Needs Case? Specifically do you agree with our proposal to approve a 600MW link if Viking Energy Wind Farm secures a CfD in 2019?

We agree that it seems logical to approve the 600MW link if Viking Energy Wind Farm secures a CfD, as NGESO's analysis shows that it would deliver the best long-term value for money under a range of generation scenarios.

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

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

Question 8: Do you agree with our proposal not to competitively tender the Shetland 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 Shetland project to be competitively tendered. 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 Shetland project is due to start construction in 2020 and be complete by March 2024, and until the outcome of the 2019 CfD auction is known it is uncertain whether the link will be needed. By the time this auction is complete, there would not be time to run a tender to appoint a third party to deliver the project. Running a competition while there is still significant uncertainty around the project itself may result in wasted tender costs, and would not be in the consumer interest. Additionally, enabling legislation would be required to implement the CATO model.

We also 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 status quo RIIO SWW delivery arrangements?

Based on the information published by Ofgem, we do not agree that using the Competition Proxy Model for Shetland 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 Shetland transmission project. The reliance on these inappropriate and selectively used benchmarks results in an artificially low cost of capital. Despite the use of project finance benchmarks for the operations phase we have seen no evidence to confirm that Ofgem has taken into account the required transfer of risk and the consequential increase in capital costs typically seen as a part of a project finance structure. This increase in capital costs (typically as a result of an EPC wrap³) is required to give investors comfort that the revenues received in operations will be sufficient to service the high level of debt and provide for an adequate equity return.

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 factors can be expected on an ex ante basis to add consumer value. Capturing a low cost of debt is based on a misunderstanding of the dynamics of debt markets, realising value from high gearing contradicts the established corporate finance principle that firms cannot lower their cost of capital by simply increasing leverage, and Ofgem's attempt to capture a low operational rate of return by benchmarking against the OFTO regime does not account for the

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

³ An EPC Wrap is an agreement that places the risk for engineering, procurement and construction of a project mainly with the contractor.

differences between that regime and the CPM. The lower WACC figures observed in Project Finance are the result of transferring risk to other parties, which comes at a cost. 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.

We note that Ofgem has not published an impact assessment specific to the use of the CPM for the Shetland project. As such, we cannot comment on that impact assessment. However, based on the generic Impact Assessment we have seen, we would not expect there to be any consumer benefit once 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 Ofgem plans to publish an update to these parameters, and we would also recommend that the forward curve is used to forecast the relevant costs of debt at the times when they will be set under CPM. We would encourage Ofgem to publish a revised impact assessment to reflect these updates which we expect will result in a reduction in consumer benefits.

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 Shetland 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.

On the basis of the above, it would therefore be unjustified for Ofgem to depart from the existing and 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 Shetland project?

Ofgem states that it intends to publish an updated set of CPM parameters later in March, and consider how predicted operational parameters will change during construction. Once this is available, we would expect to see an updated consumer benefit analysis for the Shetland project which takes account of these updated parameters.

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.

It is not clear why Ofgem has assumed that the Shetland project could achieve a credit rating of A during construction. We would expect that the Shetland project, similarly to Hinkley-Seabank, would not have credit metrics consistent with an investment grade company when assessed as a standalone entity.