Scottish & Southern Electricity Networks

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26 November 2019

Dear Thomas,

## Hinkley-Seabank: Consultation on Ofgem's updated delivery model minded-to position

Scottish Hydro Electric Transmission plc (SHE-Transmission) welcomes the opportunity to respond to Ofgem's consultation on the updated delivery model minded-to position for the Hinkley-Seabank electricity transmission project, published on 15 October 2019.

SHE-Transmission's view in respect of the Competition Proxy Model (CPM) has been discussed at length in response to various consultations, in particular Ofgem's minded-to position to apply CPM to the Orkney, Western Isles and Shetland electricity transmission projects (together 'the Islands')[1]. We are not proposing to repeat our analysis as part of this response whilst noting that our position remains unchanged.

SHE Transmission continues to aver that Ofgem's proposal to depart from the SWW mechanism for RIIO-T1 transmission projects currently in development, is wrong in principle and inconsistent with Ofgem's statutory duties. We also oppose the development of CPM as an integral part of the RIIO-T2 framework and will engage with Ofgem as the development of RIIO-T2 progresses.

## Consultation Questions

### Question 1: Do you agree with the findings of our analysis?

Whilst we agree with the conclusion of Ofgem's analysis (i.e. not minded-to apply CPM), we continue to have serious reservations with Ofgem's methodology.

Ofgem's 'point in time' analysis has led to the prevailing price control arrangements (i.e. SWW) as the preferred delivery model. This serves to demonstrate one of the major limitations in Ofgem's development of CPM. It is opportune for Ofgem to separate a major project from the

[1] https://www.ofgem.gov.uk/electricity/transmission-networks/critical-investments/strategic-wider-works/scottish-island-links

RIIO portfolio and subject it to a different methodology that may deliver a lower allowance for the cost of capital at a point in time.

In addition, Ofgem's analysis of CPM contains no cost associated with the regulatory uncertainty of applying CPM. Any reopening of fundamental parameters of the price control is likely to undermine confidence in the regulatory framework and have a detrimental impact on consumers, the implications of which need to be considered.

We continue to note several concerns in relation to the approach that Ofgem has adopted to calculate the allowed financing cost under CPM in our response to Q2. This is despite significant feedback and empirical evidence provided by SHE-Transmission (and other TOs) to demonstrate that CPM significantly undervalues the cost of capital associated with delivering major upgrades to the electricity transmission system in Great Britain.

## Question 2: Are there any additional factors that we should consider as part of our analysis and/or decision on whether to apply the CPM or SWW as the delivery model for HSB?

Yes, as noted above, SHE-Transmission has provided a significant amount of analysis and evidence to demonstrate the CPM is deficient in calculating an allowed financing cost under RIIO-T1. Ofgem's approach contains many material errors that fatally undermine its conclusions on the alleged and/or potential customer benefits of the CPM.

The CPM is based on incorrect and inconsistent assumptions, as the competition conditions it seeks to replicate are unrealistic and incorrect. In particular, as contained within previous consultation responses, SHE-Transmission has highlighted[2]:

- The incorrect comparators Ofgem has used to set the CPM cost of capital (i.e. it is far from obvious that any of the OFTO projects cited are reasonable proxies);
- Ofgem's continued assertion that enabling higher gearing during the operation phase will result in lower financing costs, which is inconsistent with well recognised and accepted finance theory;
- The overestimation of gearing in the operations phase as a result of applying a starting (high) level of gearing to the whole duration of the operations phase;
- An underestimation of the project's asset beta during the construction phase; and
- Allowing for the increased cost of regulatory uncertainty as a result of the application of CPM.

Failing to address these leads us to conclude that CPM is not an appropriate financing vehicle in this or any subsequent price control. Should Ofgem address the issues previously

[2] Note: this is a non-exhaustive list. Please refer to SHE-Transmission's response to the respective delivery model consultations on Orkney, Western Isles and Shetland electricity transmission projects.

highlighted, it would become clear that CPM is not beneficial for consumers and should be disregarded for consideration as part of RIIO-2.

We also note within the consultation *'we [Ofgem] may in future decide to apply the CPM in cases where the consumer benefit is finely balanced in order to achieve the hard to monetise benefits set out above'* (p.6 and 28). The hard to monetise benefits include, locking in current rates and making use of market-revealed project specific benchmarks. It is our view that any decision to apply CPM where the outcome is 'finely balanced' would be inappropriately "gambling" on the outcome of interest rates in the future, putting the risk on consumers.

If you would like to discuss any part of our response in more detail, please do not hesitate to contact me.

Yours sincerely

Steven Findlay
**Regulation Manager**
SHE-Transmission