SP ENERGY NETWORKS

Network Planning & Regulation

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Dear Tom

Hinkley-Seabank: consultation on our updated delivery model minded-to position

This response is from SP Transmission (SPT), the onshore transmission owner (TO) for the South of Scotland. As a TO, we have a duty to ensure that we develop and maintain an economic, efficient and coordinated onshore transmission system. We therefore welcome the opportunity to share our views on the updated delivery model for the Hinkley Seabank (HSB) project, a project which we have been following closely given our interest in the Competition Proxy Model (CPM) delivery model.

1. Do you agree with the findings of our analysis?

We welcome Ofgem's decision to propose funding delivery of HSB through the Strategic Wider Works (SWW) mechanism, rather than through the CPM. In the case of HSB, Ofgem *"do not consider that there is clear evidence in this case that applying the CPM (and therefore departing from the existing SWW arrangements under RIIO) is in the interest of consumers[1]"*. We agree with Ofgem that SWW is the right delivery framework for this important, strategic infrastructure.

CPM as a delivery mechanism for large, strategic infrastructure

Having reached this conclusion however, Ofgem states in this consultation that it still believes that projects delivered under the CPM can replicate the benefits of a fully competitive approach. These are[2]:

- *"The locking in of debt and equity rates that reflect current market rates, which remain low historically;*
- *Making use of market revealed project-specific benchmarks where appropriate (such as using observed OFTO rates for the operational period);*
- *Enabling a higher gearing during the operational period, through a project-specific risk allocation, resulting in lower overall financing costs."*

Throughout the CPM licence drafting workshops and in responding to consultations in relation to the CPM, SPT has consistently argued that Ofgem and their economic advisors' (CEPA) methodologies and assumptions on the cost of capital methodology are flawed, and that it is difficult to replicate the

1 Ofgem (October 2019), Hinkley-Seabank: Consultation on our updated delivery (p33)
2 Ofgem (October 2019), Hinkley-Seabank: Consultation on our updated delivery (p.27)

outcomes of a competitive process for assets, when there has been no competition. Our concerns with the cost of capital methodology used by Ofgem and CEPA, as highlighted by our economic consultants NERA in their "Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments" report, remain[3]. In line with the arguments we have raised in our previous consultation responses on the CPM, Ofgem's statements (above) do not support their conclusion to apply the CPM to projects during RIIO-T1 and RIIO-T2 for the following reasons:

- The locking in of cheap debt rates is conceptually flawed and unlikely to be delivered in practice. In fact the RIIO approach will provide for a lower cost of debt allowance than Ofgem's proposed CPM approach.
- The use of OFTO comparators to justify the CPM is flawed, with key elements such as the cost of equity and gearing, being misinterpreted by Ofgem. We also do not consider the OFTO regime to be an appropriate comparator for electricity transmission. SWW projects are likely to be integral to the wider network and would be significantly more complex to design, build and operate than OFTO systems. There are also key differences in the licences of TOs and OFTOs, which will have an impact on the costs and risks of those businesses and so the cost of capital which they require.
- Ofgem is assuming that higher leverage means a lower cost of capital, because debt is cheaper than equity. However, the cost of equity increases with financial leverage, as with an increasing debt interest cost and prior claim on cash-flows, equity returns become riskier. The theory (known as the "irrelevancy proposition") and the applied rule of thumb is that gearing does not overly affect the weighted average cost of capital.

The application of the CPM is also likely to pose significant financial issues if SPT were to deliver a project under this mechanism. Questions remain as to whether the CPM could actually be financed through the corporate finance structure of SPT, in particular, adopting the 'project finance' approach that Ofgem suggests. Even if SPT could, the CPM as a delivery mechanism lacks the precision and policy certainty required by third parties to secure investment on a project finance basis.

There is also uncertainty as to whether SPT would be able to maintain investment grade ratings, if it were to deliver a project under the CPM, which is a key requirement of SPT's transmission licence obligations.

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?

<u>Inclusion of the CPM in the RIIO framework</u>

Whilst Ofgem has taken the decision not to apply the CPM to HSB, SHE-T's subsea link proposals from the Scottish mainland to Orkney and the Western Isles, provided they meet certain thresholds, are still currently intended to be delivered in RIIO-T1, under the CPM mechanism. We continue to hold the view that Ofgem cannot introduce the CPM in RIIO-T1 without doing even greater damage to regulatory certainty, undermining investor confidence in the RIIO framework. Such regulatory

[3] NERA (2018) "Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments"

uncertainty within the RIIO price control framework will only serve to drive consumer (dis)benefit even higher.

Despite having reached the conclusion that the CPM will not deliver additional consumer benefits for HSB, Ofgem continues to see a role for the CPM in RIIO-T2. "*Having developed the CPM in advance of RIIO-2 in the absence of alternative competitive models, and as an integral element of the RIIO-2 price control framework, we may in future decide to apply the CPM in cases where the consumer savings appear finely balanced in order to achieve the hard to monetise benefits set out above*"[4]. In SPT's view, the CPM mechanism should only be applied where there is a demonstrably clear consumer benefit to do so. At present, we do not see any consumer benefit in the CPM.

Scope of the CPM delivery mechanism

Our concerns with the CPM as a delivery mechanism also remain. There is still no standalone CPM policy, more so now that the HSB project, which was the main conduit for the development of the CPM mechanism is now being delivered by a different mechanism. There also continues to be a lack of understanding as to the scope of the CPM mechanism. Should Ofgem intend to introduce the CPM into our RIIO-T2 licence, we are keen to understand how this would be achieved in practice. Despite a series of workshops on the development of the CPM licence conditions, there is still a considerable amount of work to be completed on the proposed licence conditions. We do not consider the current licence drafting is fit for purpose for inclusion in the draft RIIO-T2 licence.

Having reached the view, "*we can no longer be confident that applying the CPM to HSB will deliver greater consumer benefits than the status quo SWW arrangements*"[5], Ofgem should not be considering the CPM as an appropriate delivery model for large, strategic infrastructure projects in RIIO-2. Given the CPM was the preferred delivery model for the delivery of the HSB project, if consumer benefits cannot be delivered from this mechanism for this particular project, we do not believe there is any reasonable prospect that the CPM can derive additional consumer benefits from other high value, strategic projects. We would instead suggest that Ofgem focuses on the updated version of SWW for RIIO-2, the proposed new Large Onshore Transmission Investment (LOTI) mechanism. We look forward to working with Ofgem to help further develop this new mechanism.

I would be happy to answer any further questions that you may have.

Yours sincerely

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[4] Ofgem (October 2019), Hinkley-Seabank: Consultation on our updated delivery (p6)
[5] Ofgem (October 2019), Hinkley-Seabank: Consultation on our updated delivery (p33)

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