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**CATO Consultation Responses**

Att: James Norman
Transmission Competition Policy
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11th January 2016

Dear James,

**Subject: Extending Competition in Electricity Transmission: arrangements to introduce onshore tenders – Consultation Responses**

We are pleased to submit our responses to the consultation issued by OFGEM with regards to Transmission Competition on the 19th of October.

Abengoa is an international leader in design, construction and operation of transmission assets up to 800kV. From our background and experience, we see in the United Kingdom the proper base conditions for a healthy long-term oriented competition process for construction and operation of transmission assets.

However, we believe that there are some topics in which OFGEM should take special care and consideration in the decisions made as they are key to the success in the long term of the process. These are described within this document.

The Transmission Competition process has numerous issues which need to be consulted and agreed on such as incentive packages, transfer of existing assets to the CATO, tendering of HVDC projects, and many more. We would like to take this opportunity to suggest OFGEM to run discussion forums for each of the major issues with a reduced number of participants (less than 10 in each circle) and select their participants within the companies which have expressed their interest in the process. We certainly believe that this would assist OFGEM in properly gauging the industry's response and position towards the process as it evolves. We would be pleased to actively participate in these should OFGEM decide to set them up.

Many thanks.

Kind regards,

Pablo Infante Cossío
Executive VP Business Development

## Chapter 2: What will be subject to competition and how will we identify those projects?

*Question 1: What are your views on the proposed detailed interpretations of new, separable and high value (the 'criteria')?*

*Response:*

New: Without being involved in the design and construction of an asset, there are obvious inherited risks in relation to the condition of the asset itself, among others, when transferring an existing asset to a CATO.

We deem acceptable that the incumbent TO execute any necessary connection works on an existing asset with the supervision and collaboration of the CATO, in order to ensure an adequate progress and execution of the works. We are also open to the possibility of reflecting the transfer of the asset in an independent agreement to the CATO license itself.

Separable: The asset limits must be clearly identifiable in order to easily establish ownership boundaries. There must be clear and pre-established criteria for OFGEM to mediate in any conflict of responsibility between the CATO and the adjacent TO's.

It is indeed not necessary to have redundancy of protection equipment due to different ownerships at the interfaces, but it would be good practice. However, it might not deliver Value for Money to the end customer.

High Value: We agree with OFGEM with the "high value" description described previously. Ideally, it would be desirable to apply a "whole-life-cost" approach to determine whether a project is susceptible to procurement through CATO or not, but we do not believe this approach is practical and appropriate to this process.

We believe that a threshold of 100MGBP CAPEX (not whole-life-cost) is reasonable and represents an appropriate balance between the savings by procuring the project via CATO and the additional competition costs.

*Question 2: Under what circumstances do you think asset transfer from an existing asset owner to a CATO would be required, recognising the principle that projects identified for tendering should be new?*

*Response:*

As a rule of thumb, we agree in principle on accepting the transfer of an asset from the incumbent TO to the CATO when the actions of the CATO over the asset generate sufficient value to the asset itself.

We agree with OFGEM's proposed views on the fact that an in depth due diligence must be made with regards to the current situation of the asset and, furthermore, the incumbent TO must be kept responsible of any conditions precedent which may come up during the CATO's ownership of the asset.

Nevertheless, we do not consider that the CATO is the best placed to assume the costs generated from this transfer process, as it would not generate value for money to the end customer.

*Question 3: What are your views on our proposal that electrical separability should not be required at each interface, but that the SO can propose it to us if it thinks there is a cost-benefit justification based on system operability?*

*Response:*

Electrical separability and, furthermore, redundant protection and breaking equipment would indeed facilitate greatly the identification of responsibilities under a fault not cleared which result in damages to certain assets, leading to reduction of availability and therefore affecting the income of the CATO.

However, we understand that electrical separability is not necessarily a requirement for a project to be tendered under CATO regime, in accordance with current OFGEM's views, as it will not generate Value for Money to the end customer.

The benefit of not increasing the CAPEX of the project by ensuring electrical separability by means of additional equipment, which is not necessary for the normal operation of the grids, will only be realisable if accompanied by a clear and direct intervention of OFGEM in any responsibility dispute process.

*Question 4: What are your views on the suggested process and roles for identifying projects for tendering?*

*Response:*

We agree with the roles and processes identified on OFGEM's last document for identifying projects for tender. We believe that the SO is best placed to determine the grid needs and that the criteria are adequate, considering the comments stated in Question 1 of this block of questions.

We understand that the SO must be involved in the development, planning and transfer of the assets (if needed), as mentioned before, as well as in the definition of responsibilities in situations where faults on the grid affect the availability of the CATO asset. The latter role is fundamental for the correct operation of the grid and will underpin effective investment if ensured from the very beginning.

Furthermore, we believe that the, as far as reasonably possible, it should be the norm to tender projects under CATO, not the exception.

*Question 5: What incentives and obligations should the SO and TOs have for undertaking preliminary works for tendered projects, and is there any value in considering a success fee incentive?*

*Response:*

We do believe there is value in considering a success fee incentive for the SO and TOs with regards to fulfilling their duties in undertaking preliminary works for tendered projects. Ideally this should not be necessary but this would ensure alignment of interest of all parties towards the projects.

The value of the fee should be linked to the completion of a series of goals for the TO/SO, set from the start, and to the adequate progress of the project based on the information available. Therefore it is envisaged that certain payment milestones will have to be established.

The maximum value of the fee has to be set by OFGEM for all tenderers and considered as an input to the model.

With regards to obligations of the TO/SO:

- A jointly agreed programme of works for the project has to be established the moment a CATO is appointed. The programme must show the overall milestones across planning and development, design, construction and O&M and the owners of each of the activities, making all parties accountable.

- The developer must have contractual obligations and penalties for un-fulfilment of their milestones – the same way the contractor does.

- Any penalty possibly applied to them should be independent of the chosen CATO and should reflect both

    - Impact on the grid for that particular asset not being in place

    - Impact on the CATO for standstill prelims or other commercial implication.

- TOs and SO should be accountable for the quality of the development works and should be kept accountable if any assumption used by the CATO for tendering the works, based on the available information, turns out to be inaccurate or wrong.

*Question 6: Should CATOs pay for the preliminary works at the point of transfer?*

*Response:*

We believe that, even though the CATO could pay for the preliminary works at the point of transfer, it is most cost effective for the project to finance the early works via the tradicional way (i.e. through OFGEM). Should OFGEM decide to finance the early works through the CATO, the CATO will apply a fee and will impact negatively on the end consumer. This second option is less cost effective than the traditional one, as it would only change the source of funds but no competitiveness could be introduced on the development works by the CATO.

**Chapter 3: How will the tenders work and what will the CATO's get?**

*Question 1: What are your views on our proposed late CATO build tender model? Including:*

- *The basis of bids;*
- *The use of cost sharing factors; and*
- *What risks, if any, it would not be efficient for a CATO to manage during construction.*

*Response:*

We agree in the assumption that the best approach for pricing competition within the tender model is a CAPEX based approach. The bulk of the costs of the project will be covered under CAPEX and it greatly simplifies the quantification process against the Whole-Life Cost approach.

With regards to the proposed timescales, we would like to strongly advice not to commence the ITT process until all applicable permits are achieved by the SO. The tender costs for the industry (both private sector and regulator) will be quite significant and it is not advisable to put them at risk by kicking off the ITT works without full planning consent (and other necessary consents) in place. On the contrary, the PQQ costs, though important, will be significantly lower than the ITT costs and for sake of effectiveness and keeping up with timescales it can be acceptable to run the PQQ in parallel to the planning process. If the latter occurs, it is desirable to run the PQQ as late as possible to ensure that the supply chain is engaged formally and the process is not taken by the industry as an "indicative" or "too-far-down-the-road" opportunity.

With regards to cost-sharing factors, from OFGEM's point of view, as these projects will be an OPEX model for them (payment based on availability on operation, no payments during construction) we believe that a fixed O&M cost with its availability incentives, as described in the consultation documents and further down in this document, is appropriate. We do not believe that a cost sharing approach between the CATO and OFGEM would be adequate, as the certainty provided in the fixed "canon", on which the tender is based, is most beneficial for the customer in comparison with the complicated

In terms of risk management, in the Late CATO build model, we understand that it might not be efficient for the customer that the CATO manages the "Right of Way" or any other risks related with management of permits and accesses. It is appropriate that the CATO manages those permits and use them for entering the site and executing the works but should something be wrong with those permits which would have been achieved by the SO, the SO should response and be accountable to those risks.

*Question 2: What are your views on our proposed Early CATO build tender model?*

*Including:*

- *What tender specification would best facilitate innovative but deliverable bids; and*
- *How we can best manage cost uncertainty after the tender.*

*Response:*

With regards to the Early Model CATO build:

We see two major issues/topics to discuss here: how to structure the commercial arrangements during planning process and how to effectively assess the competitiveness in the construction and O&M works of the CATO's without having a detailed design and having so many uncertainties in the design.

With regards to the first issue, we believe that two completely different commercial approaches should be taken in development, EPC and O&M stages, almost as if they were two different contracts. Furthermore, there are large uncertainties during development stages which will need to be managed and structured commercially in the contract.

- During the Initial Solution Design, Undertake Surveys / Studies, Obtain Consent phases (as per Figure 1, page 17 of the Consultation Document issued on the 19th October 2015) we propose to employ a capped emerging cost contract. This contract would operate in the following manner:

1. The bidders would propose an initial cost extension for the development activities, based on a series of assumptions set by OFGEM beforehand. A schedule of rates for staff would be attached to the cost extension submission, along with a fixed initial target fee.

2. The cost extension would be billed monthly to OFGEM whereas the target fee, if any, would be billed to OFGEM only at completion of the services.

3. Any costs outside the assumptions which emerge during the development will be agreed and charged at the rate shown in the schedule of rates or, if no rate is applicable, as an incurred cost plus a fixed fee (i.e. additional consultant bills) and will automatically raise the cost cap.

4. If the bidder overruns the cost and reaches the cap before finalising the activities, a cost extension would be requested to OFGEM, explaining the reasons for the request. OFGEM would assess the impact in cost and would grant an extension along with a reduction on the target fee.

5. At the end of the development process, the bidder would have received the reasonable cost extension of the development plus the development fee decreased in relation to any cost extension requested.

6. Once the development works are finished, the commercial structures applicable to a Late Model CATO build would apply as well.

With regards to Pricing and assessing the competitiveness of the CATOs in the construction works:

- In an Early Model CATO build tender, very little information will be available for the bidders to build up a reliable, though indicative, cost. We do not see the real application and usefulness of providing this figure, as it is suggested in the consultation documents. The figures will be based in a large number of design assumptions which will not necessarily be realisable and, furthermore, will most certainly differ from other bidder's design assumptions. Due to this, indicative cost estimations cannot be used for comparison of tenders and therefore it is of no use to provide them within the tender itself.

- However, we understand that not providing an indicative cost could mean to appoint a CATO to eventually construct a transmission project without any assessment of the competitiveness of the CATO in performing the construction works. A possible solution to this issue is to tender as well a firm schedule of rates for an ad-hoc Assessment Project / Case Study (i.e. create a project description and price the works against it). These schedules of rates (labour, plant and materials rates) will be used with appropriate indexation factors, etc. in the build-up of the firm EPC price after planning consent. This would tie the CATO's to firm prices within the Early Model CATO build tenders and therefore enable OFGEM to compare the CATO's competitiveness in this tender models.

*Question 3: Do you have any views on the best way to tender projects using High Voltage Direct Current (HVDC) technology?*

*Response:*

- Actually, there are currently long lead times for supply elements for convertor stations and HVDC cables, driven by limited production capacity and high demand. We understand that there is currently no absolute certainty of securing a delivery date from a manufacturer until contracts are signed. Finalising contracts may rely on consents being secured or relevant generators making investment decisions, which in turn may impact on the date by which the CATO could ensure its project is operational. Therefore we understand in would be better for the CATO lines try to use this technology only when it´s necessary, it is said, only in really long distance projects because this technology is more expensive, so it shall implies a higher cost for the final users.

*Question 4: Do you have any views on our proposal to prioritise late CATO build? Do you have any views on specific circumstances where early CATO build might lead to better outcomes than late CATO build?*

*Response:*

We are in favour of prioritizing the late CATO build tender model in the first round of projects. The late CATO build model propose a more appropriate distribution of risks between the SO and the CATO and, in the short term, will be more attractive for the tenderers as it will enable them to focus in their strengths and propose more competitive tenders.

However, in future rounds, we see benefits in using Early Model CATO build tenders only in projects which would not seem to pose major planning difficulties. This would enable the CATO to focus on achieving planning consent as competitively as possible, in time and budget, which is the major uncertainty that the planning process brings up. This would also facilitate OFGEM the assessment of the bidders under the Early Model CATO build.

*Question 5: Do you have any views on how we could mitigate the risk of a CATO not being in place?*

*Response:*

There are two main stages in which the Project can suffer delays: development / early works / engineering and during construction.

To avoid delays during the initial phases, we suggest a late model is adopted, as it is currently proposed by OFGEM, but with the incentives and controls described before in this document.

During construction phases, there are traditional means such as security packages, etc. through which the CATO is incentivised to progress according to the plan as well as mechanisms to articulate a quick substitution of the CATO should it not perform according to the standards.

*Question 6: What are your views on our proposed revenue package for CATO's? Including:*

- *The proposed duration of the revenue term, including how it links to the asset cost recovery period and whether operations and maintenance costs can be fixed over this period; and*
- *Our proposed approach to indexation, refinancing and enabling new asset investment.*

*Response:*

No less than 25-year revenue stream during operation.

We would endeavor 2 revenue streams: 1 for project costs recovery over a minimum of fixed 25-year revenue stream subject to underperformance risk capped at a maximum 10% of revenue; and another revenue stream to cover

O&M costs during the the asset life where costs could be fixed and linked to inflation.

For bid comparison purposes, indexation must me fixed in the tender documents so that bidders would have the same approach to inflation. Open indexation approaches may distort competition and equal and fair valuation of bids.

Refinancing potential benefits should not be shared as this would potentially increase competition during the bidding stage considering different potential financing structures and refinancing scenarios for bidders.

*Question 7: What are your views on our proposed package of financial incentives for CATO's? Including:*

- *How we could structure an availability-based incentive to ensure CATO's operate their assets with a "whole network" view;*
- *The proportion of a CATO's annual revenue that should be at risk; and*
- *Whether there are circumstances under which "payment on completion" would not be appropriate to incentivise timely asset delivery.*

*Response:*

In our opinión, a "risk model" versus an avalability model shall be more expensive for final users because the CATO must consider risks levels higher in its financial model.

Avalability-based incentive is adequate, given a cap for underperformance of 10% of annual revenues at risk. Payment on completion would be beneficial for the financiability of the project and to incentivise construction on time and to reduce financing costs.

*Question 8: Are there other types of incentives not covered in this chapter that you think should apply to CATO's?*

*Response:*

Tax exemptions could prove beneficial in several ways: would attract further overseas participants, underpinning competition, and would reduce the tariff received by the CATO therefore creating Value for Money for the end consumer.

**Chapter 4: How will the tenders work and what will the CATO's get?**

*Question 1: Are there any risks or conflicts of interest arising from the SO's role that we haven't identified?*

*Response:*

We believe that all reasonable risks or conflicts of interest arising from the SO's role have been properly identified and described at this stage. However, we suggest OFGEM consults on this again further down the process.

*Question 2: Are there any risks or conflicts of interest arising from the participation of incumbent onshore TO's that we haven't identified?*

*Response:*

We believe that all reasonable risks or conflicts of interest arising from the participation of the incumbent onshore TO's role have been properly identified and described at this stage. However, we suggest OFGEM consults on this again further down the process as this is a key issue which can determine the success of the CATO tendering system.

*Question 3: Are there any additional conflicts of interest that we haven't identified?*

*Response:*

We believe that all reasonable conflicts of interest have been properly identified and described at this stage. However, we suggest OFGEM consults on this again further down the process.

*Question 4: What measures do you think would be appropriate to mitigate the risks and conflicts of interest? What additional conflict mitigation measures would be needed if the SO takes on a broader role in supporting competition?*

*Response:*

We believe that, should the SO take on a broader role in supporting competition, the participation of itself in the competition should be questioned. We suggest OFGEM consults with regards to this issue further down the process when more detailed information is available.