Mermaid House | 2 Puddle Dock | London | EC4V 3DB
T: 020 7332 2950
www.centrusadvisors.com

Transmission Competition Policy
Ofgem
9 Millbank
London, SW1P 3GE

FAO: James Norman

11th January 2016

Dear James,

Extending competition in electricity transmission: arrangements to introduce onshore tenders – Centrus Advisors LLP response

I am pleased to provide you with our response to your consultation document "Extending competition in electricity transmission: arrangements to introduce onshore tenders" dated 19 October 2015.

Centrus Advisors is a financial advisor specialising in the economic and social infrastructure sectors in the UK and Ireland and has broad experience of financing electricity transmission and other essential service assets. We are also very experienced in the institutional and bank lenders' attitudes to the risks and issues that onshore electricity transmission owners will face.

As you will be aware, we held a seminar in early December 2015 on the opportunities for prospective owners and operators presented by competitive tenders for UK onshore electricity transmission assets. The event was very well attended and participants were very excited by the proposed structure of the opportunity to enter this new market.

We welcome the opportunity to express our views on selected financing related questions that you have posed in the consultation process. Please see attached our responses with reference to the relevant question and chapter of the consultation document.

Yours sincerely,

Geoff Knight
Partner
Centrus Advisors LLP

Appendix 1

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

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?

From a financing perspective, it is essential that there is absolute clarity in respect of the responsibilities and liabilities of the CATO and in particular as they relate to other asset owners to which they connect. While there will inevitably be debates about warranties and other required assurance regarding transferred assets, this upfront negotiation will be more robust from a financing perspective compared to uncertainty regarding liabilities. Where asset transfer provides clarity, therefore, it should be encouraged.

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?

We believe that incentivising the SO and TOs for undertaking preliminary works will be desirable for facilitating tendered projects. In return for appropriate incentive payments, it would be helpful if a standard form of warranty and liquidated damages package was pre-agreed for these works such that they can be assigned for the benefit of both the CATOs and their lenders. The level of warranties and liquidated damages negotiated should reflect the appropriate value for money tests and may differ between tendered projects. We note Ofgem's suggestion that a licence condition could replace the economic effect of indemnities being provided to the CATOs and are supportive of this proposal.

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

From a financing perspective, where the CATO does pay for preliminary works, this structure is likely to be preferable because the alternative is the need for committed undrawn future funding which introduces unwelcome credit risk.

Chapter 3 - How will the tender work and what will CATOs get?

Question 1: What are your views on our proposed late CATO build tender model? Do you have any views on the basis of bids, use of cost-sharing factors or what risks, if any, it would not be efficient for a CATO to manage during construction?

From a financing perspective, most of the uncertainties and risks that a CATO will face during the construction phase need to be capable of being "bundled" and pushed down to experienced EPC contractors. Funders are used to the retention of some residual risks such as bid costs and project/subcontractor management but these can be capped and are relatively predictable. The advantage of late CATO build tenders (compared to early CATO build tenders) is the level of cost and funding certainty required in higher leverage/ project financing structures particularly where capital markets fixed rate finance is envisaged and a fixed WACC is set up front.

Where appropriate cost sharing risks are not able to be pushed down to EPC contractors, contingent equity is likely to be required which is inefficient and likely to result in sub-optimal bids. It is, therefore, recommended that the risks that are left for the CATO to manage during construction and are limited to those that can be pushed down in EPC contracts. On complex projects where EPC contractors are not willing to offer competitive fixed price contracts that effectively cater for cost *overruns, the regulatory regime needs to be flexible enough to cater for efficiently incurred capital expenditure and compensate CATOs for the costs of capital prevailing at the time the additional capital is introduced. Where such additional funding risk remains unmitigated, bidding consortia are likely to resort to cautious, suboptimal financing structures which partly defeats the purpose of the competitive tenders.*

Question 2: What are your views on our proposed early CATO build tender model? Do you have any views on what tender specification would best facilitate innovative but deliverable bids, and how we can best manage cost uncertainty after the tender?

Building on our answer to Question 1 above, the early CATO build tenders present more challenges in respect of fixing long term finance. While it is clearly preferable to facilitate innovation, and therefore early CATO builds tender models should be encouraged, Ofgem should consider whether consumers will be best served where the early CATO build tenderers are required to take the same risks as late CATO build bidders or indeed OFTO bidders. Since early CATO build tenders are likely to have more risks to the variability of cash flows, an option would be to assess tender bidders on their required equity returns for a given leverage assumption. This could be combined with allowing a long term debt funding competition to be conducted either at the late CATO stage or on completion of the asset with consumers taking the risks of higher or lower debt financing costs as they largely do now under RIIO.

Also, one must consider carefully the additional bid cost risk for tenderers associated with the early CATO build tender model. Inevitably this will lead to equity sponsors requiring higher IRR's (resulting in lower bid levels) and possibly a lower level of tenderers. One possible solution for this is to allow a level of bid cost risk recovery to losing bidders at the appropriate stage of the competition.

Question 6: What are your views on our proposed revenue package for CATOs? Do you have any views on 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? Do you have any views on our proposed approach to indexation, refinancing and enabling new asset investment?

We broadly agree with the proposed revenue package for CATO's with the exception of the suggested amendments that we have set out in question 2 above. From our experience we believe the term of the proposed licence will attract both bank and institutional financing interest and therefore is appropriate. In addition, we would agree that the proposed residual value at the end of the licence term should not be a problem from a financing perspective as long as the basis for valuation and recovery of value is clearly set out in the licence.

Question 7: What are your views on our proposed package of financial incentives for CATOs? Do you have any views on how we could structure an availability-based incentive to ensure CATOs operate their assets with a 'whole network' view? Do you have any views on whether there are circumstances under which 'payment on completion' would not be appropriate to incentivise timely asset delivery?

We broadly agree with the proposed package of financial incentives but suggest that where the risk of "payment on completion" cannot be pushed down to an EPC contractor where, for instance, the project construction is particularly complex or uncertain, that flexibility is retained to allow the CATO to receive revenues at a fixed date where other conditions are met.