

Our Ref MR/SS

For the attention of James Norman

8 January 2016

Dear Sirs

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## **Response to consultation on extending competition in electricity transmission: arrangements to introduce onshore tenders**

We have pleasure in enclosing our response to the above consultation.

We have responded to specific questions where we believe our experience as a leading advisor to the public and private sector on major infrastructure projects is relevant. To date Grant Thornton UK LLP has advised on more than 200 projects with a combined capital value of over £20bn, including working with Ofgem on the successful high-voltage transmission links for four offshore wind farms as part of the Transitional Tender Round 2 projects with a capital value in excess of £1bn.

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Through our government & infrastructure advisory team we have a pool of specialist staff dedicated to the delivery of services including financial advisory, infrastructure and project finance work, audit, taxation and consulting services to government departments, local authorities, government agencies and not-for-profit organisations in the UK and overseas. We deliver value-for-money and bespoke solutions that recognise the unique demands of each client context. This has included shaping and delivering on large programmes across a range of sectors including transport, health education, social infrastructure as well as waste and energy. Within that advisory business we have a team that focusses solely on the energy and environment sectors. That team has undertaken advisory and fundraising on a range of energy projects including onshore wind. In addition and of particular relevance to this consultation, we provided financial and commercial advice to Ofgem on the Round 2 OFTO procurements, and we undertook an independent evaluation of the roll out of Electricity Market Reform for DECC.

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## Response to Consultation Questions

Note that we have only responded to selected questions (see Appendix 1) where we believe we can add useful insight and commentary – principally focussing on areas which impact on bidder or funder appetite for the regime, in order to support the development of infrastructure.

Our key points are:

- We consider the proposals to form a reasonable basis for extending competition to cover onshore transmission projects, building upon the experience from OFTOs. In order to attract bidders and funders we believe a clear view on pipeline of future projects will be important, however we recognise that this is not within Ofgem's control.
- There are clearly greater uncertainties around costs where planning has not been secured and that there are potential lessons Ofgem could learn from other infrastructure projects such as how the Waste PFI projects agreed mechanisms for adjusting costs arising from planning delay.
- Greater clarity on the proposals for the residual value payment at the end of the revenue period would be helpful so that this can be considered by funders and sponsors.

Where we have not responded to a questions this is because we do not have strong views – for example whether electrical separability is required at each interface.

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Yours sincerely



Mike Read  
Director  
For Grant Thornton UK LLP

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## **APPENDIX 1 - Our consultation question responses:**

### **Chapter 2 Question 1: What are your views on the proposed detailed interpretations of new, separable and high value (the 'criteria')?**

We consider the detailed interpretations to be a reasonable basis for extending competition to cover onshore electricity transmission. As noted in the consultation the size of projects should be sufficiently high to attract interest from bidders and funders, but in our experience it is also very important that there is a clear pipeline of projects that provides confidence to investors that the sector is worth investing in. More generally from our work on a number of infrastructure programmes, it provides a programme of activity that developers, contractors and advisors in addition to investors can build capability and relationships around. Adopting a similar approach of rounds of projects adopted for the OFTO programme would be worth considering as this will allow progressively greater efficiencies of procurement, potentially reducing costs.

We also consider there can be significant advantages in only applying this to assets that are new and separable so that risk transfer can be more clearly agreed – for example securing appropriate warranties to satisfy CATO funders.

### **Chapter 2 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?**

In addition to the requirement for ensuring the works are of high standard, a key issue for the bidders and their funders during any procurement process is the reliance they can place on the preliminary works undertaken, and any recourse to the SO/TO for implications of failures.

The greater the reliance that can be placed by the market on the quality of the preliminary works the greater the potential there will be for a reduction in due diligence costs and the need for bidders to do their own investigations. This will also have a potential additional benefit in terms of funders and developers views on approach and pricing of the risk.

Therefore any consideration of providing financial incentives to SO/TOs relating to preliminary works (which we consider has merits) needs to be done alongside exploring with SO/TOs the level of reliance and guarantees that would be provided to the prospective CATOs in respect of those works.

### **Chapter 2 Question 6: Should CATOs pay for the preliminary works at the point of transfer?**

We would suggest the experience from the OFTO regime is helpful where a fair value assessment was made for the transferring assets with a payment by the OFTO to the developer at this stage.

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We note the proposal in paragraph 1.67 for the SO to receive a success fee and suggest Ofgem may wish to consider how this is set to appropriately balance the risks taken by the SO. For example one option could be for the overheads and profit margin of the SO on its costs to be subject to the balanced score card approach but with any directly incurred costs (such as survey costs) being paid without premium or performance adjustment applying provided these are incurred in an efficient and economic manner.

One option could be for the Government to provide guarantees relating to the preliminary works, but that in turn would require recourse mechanisms for Government back to the SO/TO.

**Chapter 3 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?**

Our views are that the model represents a logical development from the successful OFTO tender regime. The use of cost-sharing factors needs to be considered carefully but these principles are well established in other procurements – for example the rail franchise tenders operated by Department for Transport frequently include some form of profit or revenue share mechanisms to reflect the fact that these are a shared risk between the operator and the public sector. It is important that any such mechanisms are transparent, and appropriately calibrated but not overly complex, so that they can be understood by parties when developing tenders.

In terms of risks during construction, the issue of reliance on preliminary works as set out in our response to Chapter 2 Question 5 is relevant.

**Chapter 3 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?**

In relation to early CATO build we note that at paragraph 3.11 of the consultation there would be uncertainties around planning consent and Ofgem would expect bidders to bid a best indicative cost for the design. We note that the experience adopted in the Waste PFI sector may be useful where designs and costs were often finalised prior to planning consent and a mechanism for applying indexation and cost adjustments arising from planning delay was agreed with the preferred bidder. We also note that some costs such as financing costs may be more appropriate to benchmark once planning approval has been secured.

We also note the proposal in table 3 at paragraph 1.117 for bidders to bid a fixed gearing and indicative cost of debt. We note that gearing levels are usually set by funders to reflect the project risk and so requiring this to be fixed may therefore limit the cost of senior debt which can be secured. We would suggest that the gearing should also be considered indicative along with the cost of debt.

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**Chapter 3 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?**

Our views are that prioritising late CATO build is sensible given the status of projects and as its complexity is less than the early CATO build it is perhaps more likely to attract a wider pool of bidders and investors. As noted in the consultation, we agree that the early CATO build provides greater opportunity for innovation in design which therefore may result in better value solutions compared to a late CATO build, however this is difficult, if not impossible, to quantify at this early stage of the process.

We would also refer you back to our response to Chapter 2 Question 5 (preliminary works risk) and the extent to which reliance can be placed by bidders on those preliminary works.

**Chapter 3 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 consider that the proposal for a 25 year revenue term reflects that of similar long term infrastructure projects seen in the market – for example on PFI projects and is longer than the 20 years offered on OFTO projects.

The approach to partially indexing the revenue stream is relevant to projects of this nature where there is a mixture of fixed financing costs and inflating operating costs. Similar approaches have been utilised in programmes such as the waste PFI programme. Allowing the proportion to be indexed / not indexed be determined by the bidder based on their solution will prevent / reduce the need for potentially expensive inflation hedging products. To ensure that value for money is achieved it will be important that the basis of this partial indexation is a component of the price evaluation of bids.

Given that a life of 45 years is applied under RIIO for similar assets we would agree that it will be important to recognise a regulatory residual value in order to ensure the costs are more appropriately allocated across generations of consumers. We have seen a number of different mechanisms used to address this in other projects, typically these involve the residual value being solely a return to equity funders or a senior loan being used as a bullet repayment where lenders are comfortable with the covenants and security packages supporting this payment. The latter option being used in a number of housing PFI projects.

We note that a number of options are set out at the end of the revenue term in paragraph 1.147 ranging from retender (where a new CATO would acquire the assets and could therefore pay the residual value) to decommissioning (where the existing CATO would incur costs in decommissioning). These options therefore cover both a revenue being received (either lump sum or over time if revenue term extended) or a cost being incurred for decommissioning. We consider that greater clarity would be needed in order for funders and sponsors to be comfortable with the residual value payment – for example we would suggest this is fixed regardless of the option chosen.

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We also consider it is important that a refinancing gain share mechanism is included to ensure consumer benefit from a CATO achieving a lower cost of debt financing during its revenue term, and note there are approaches adopted in the current OFTO regime and UK PF2 procurement models which funders and sponsors will be familiar with.

**Chapter 3 Question 7: What are your views on our proposed package of financial incentives for CATOs ? including**

**how we could structure an availability-based incentive to ensure CATO's operate their assets with a 'whole network' view**

Generally, we believe that the OFTO mechanism are an appropriate basis for an incentive mechanism.

A key aspect for incentivising over availability would be in structuring an arrangement which only provided rewards where there was value in that additional capacity (i.e. to meet other shortfalls in that network). The ability to forecast that at the outset of a 25 year contract would be very limited.

However, for example in the case of accessing the benefits of potential reduced downtime, an option could be for a mechanism linked to reviews of forward lifecycle and maintenance plans, which identified potential opportunities for greater availability could be developed, with an incentive to provide a sharing of net upside for that additional capacity.

**the proportion of CATO's annual revenue that should be at risk**

The regime in the OFTOs that limited the downside to 10% of revenues is clearly a fundable position. However, given that this does not fully compensate for unavailability this needs to be supported by the ability to apply regulatory powers relating to availability.

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