Response to Ofgem consultation: "Extending competition in electricity transmission: arrangements to introduce onshore tenders".

From: Jones Lang LaSalle Renewable Energy Capital – "JLL REC"

About JLL REC: A team of specialist corporate finance advisers supporting developers of projects as well as investors in projects, in the renewable energy generation and wider infrastructure sectors.

Contact: Mark Heuff, Director, mark.heuff@eu.jll.com; Tel: 020 7399 5319 / 07770 366 411

Responses to questions as set out in each chapter of the consultation document:

Chapter Two – 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')?*

High Value is defined as capital expenditure of £100m or above – whilst we agree that this a reasonable threshold in terms of supporting a tender process and enabling competitively priced financing we would also note that it is important that a reasonable number of projects are brought to the market to allow bidders multiple chances to bid. Therefore if the size threshold was seen to be limiting the number of projects brought forward we would recommend that it be reduced to allow a greater volume of projects and therefore bidder activity.

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?*

No response

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?*

We agree with the principle of not insisting on electrical seperability for the sake of it, provided the commercial payment terms sufficiently clear and the responsibilities and liabilities of all parties adequately covered off in the relevant contracts.

Question 4: *What are your views on the suggested process and roles for identifying projects for tendering?*
- We have proposed specific roles for the SO – do you think there are any additional roles the SO could take on to support competition?
- What's the most appropriate way to ensure that the network options assessment (NOA) considers the widest range of network options, including those that would be tendered?

Visibility over a project pipeline will be a key factor in securing investor interest as parties will want to consider their initial tendering and set up costs in light of the number of upcoming chances to bid and reuse/refine their bid process. Therefore a clear and transparent selection process with as much early visibility as possible would be recommended.

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?*

No response

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

We feel that the overall lowest cost option for consumers is for the SO to fund the preliminary works and these to then be transferred to the CATO at zero value as this then avoids paying third party finance charges on the preliminary works. We appreciate this means that current consumers will then effectively be funding the preliminary works and the reasonableness of this will need to be considered in light of the scale of the costs of the preliminary works and future pipeline which would then be funded by future consumers in the same way.

Chapter Three – How will the tender work and what will CATOs 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.

We note that the current proposal is to have an Enhanced pre-qualification stage followed by only one bid stage – ITT – before selecting a Preferred Bidder. Whilst we appreciate the intention of going for a simplified process to reduce the overall bid timeline and burden on Ofgem we are concerned that this requires bidders to undertake a very high level of due diligence at the ITT stage when there are still a large number of parties in the bid process (5 is mentioned) in order to provide final costs as required. This is likely to result in a reduced appetite from bidders to participate or in bidders including a greater element of contingencies on underlying costs, either of which would reduce the effectiveness of the bid process. An alternative approach would be to have reduced requirements at the ITT stage followed by a Final Bid stage where a smaller number of bidders (potentially only 2) undertake full DD and finalise costings to provide final bids to then be compared. If this alternative approach is adopted we would recommend that it is clearly stated from the start as if the proposed process is started but then the Preferred Bidder stage used to take 2 (or more) bidders through before making the final selection this will negatively affect investor confidence in the whole process and therefore appetite going forward.

We agree that the aim of the tender process should be to select a CATO at a known future cost and private sector bidders should therefore be comfortable to bid without cost sharing factors, but a limited number of cost reopeners or pass through costs, such as business rates and change in law events.

Key construction risks that will be outside the control of the CATO or any subcontractors will be movements in market factors such as materials inflation, exchange rates and interest rates. Whilst these can be managed through the use of financial instruments consideration could be given to the cost of these, which will vary in significance from project to project and indeed bidder to bidder, and the appetite of Ofgem to accept these risks as cost reopeners.

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.

We appreciate that a key aim of the early CATO model is to improve innovation in the initial project design by introducing competition at an early stage. This does, however, cause some significant concerns from a bidder and process perspective (when compared to the Late CATO model) such as the increased level of planning risk, reduced number of potential bidders with relevant experience, reduced bidder appetite due to longer time period to commencement of operations. The bids received under an early CATO model are likely to vary significantly from bidder to bidder in terms of cost and risk profile so will be hard to compare and contrast.

We would suggest that the SO are best placed to design and undertake the preliminary works, as per the late CATO model, and should be encouraged/incentivised to be innovative in designs.

Question 3: *Do you have any views on the best way to tender projects using high voltage direct current (HVDC) technology?*

No response

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?*

We agree with prioritising late CATO build and as above have reservations about the application of the early CATO build in the procurement process.

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

We agree with the principle of having a CATO of last resort mechanism as proposed, dependant upon the detail

Question 6: *What are your views on our proposed revenue package for CATOs? 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.

We appreciate the rationale behind selection of a 25 year revenue term and agree that this will enable bidders to access the majority of suitable funding sources to support the construction of projects. However there are some annuity funds which may be able to offer more attractive financing, depending upon the certainty of the revenue streams etc, and these may prefer a longer revenue period. We would therefore recommend that an element of flexibility is retained in relation to revenue term to ensure that all suitable funding options can be explored.

We agree that the presence of a longer asset life than revenue term creates an issue that needs careful consideration. The proposal of a 25 year revenue term with a 45 year cost depreciation term so that a residual value is paid to the CATO in year 25 solves the problem of spreading the cost to the consumer over the full 45 year term but will create potential issues for bidders that will complicate the bid process, and therefore add cost, such as:

- Calculation of the residual value;
- Security over the residual value payment;
- Requirements on the CATO in relation to condition of the asset and handover and the level of risk associated with meeting these conditions – could result in a material contingency cost being built into the bid model;

In other sectors we have seen contracts let for a period of time that is shorter than the expected assets life, such as the residual waste treatment sector, and the contract has allowed for full cost recovery during the contract term with the asset transferring to the Local Authority at the end of the term at zero value to continue in use. This approach would be most likely to support the lowest overall cost to the public in relation to new onshore transmission assets.

We agree with the approach of partial indexation, as calculated by bidders, as a method of removing indexation risk from bidders which they would otherwise need to price into bids. In order to fully remove indexation risk from bidders we would expect to see a “basket” of indices to reflect the indices of the underlying cost base, such as labour indexation, RPI etc. The basket of indicies approach adds complexity however and we would expect the majority of bidders and funders to support the use of RPI.

We would agree that the use of a refinance gain share mechanism would be appropriate as has been used successfully in other sectors and is well understood by bidders, the share of the gain to the CATO needs to be sufficient to ensure they are incentivised to refinance where it is beneficial.

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 CATOs 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.

We would agree that a 10% cap on annual revenue at risk from the availability-incentive mechanism is likely to be ok for the majority of funding options but if bidders were to look at potentially lower cost longer term annuity type funding structures (such as referred to in question 6 above) this may not be appropriate and therefore there could be some flexibility for bidders to forgoe this mechanism if it results in lower overall funding costs.

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

No response

Chapter Four – Managing conflicts of interest

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

No response

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

No response

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

No response

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?*

No response