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Ofgem
9 Millbank
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MACQUARIE

Dear James,

Open Letter: Extending competition in electricity transmission: arrangements to introduce onshore tenders

We would like to thank you for providing us with the opportunity to respond to your open letter. Please find below the response of Macquarie Capital to Ofgem's open letter in relation to extending competition in electricity transmission.

Responses to questions set out in Chapter Two:

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

   In general we agree with the interpretations of the criteria. The minimum tendering threshold of £100m per project is a good starting point, but may be deemed too small on a standalone basis to attract sufficient market competition. We therefore suggest to follow the OFTO tender model and tender multiple projects (perhaps 5 or more depending on the individual size of projects) in each round of procurement. Given the indicative nature of the asset value in the initial assessment phase, the SO's screening process should be independently monitored to ensure all suitable projects are made eligible for CATO tendering. It might be advisable to set a more flexible minimum threshold in order to avoid seeing projects with a £100m+ final value deselected because of an initial estimated value just below £100m.

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?

   In case of asset replacements, it would be important for all relevant assets to be transferred by the existing asset owner to the CATO. Moreover, in case of a new asset, there may be relevant rights (eg property) or assets to be transferred as well, especially in a late CATO model.

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 that electrical separability is not necessary for each interface, so long as availability can be measured transparently, and the responsibilities for both sides of the boundary can be defined clearly. Ideally, the boundary definition should be *determined through independent reviews. If the SO is able to propose separability, we believe it would be faced with a conflict of interest and the associated cost-benefit justification would be difficult to review.*

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?

    We view the current roles proposed for the SO as appropriate for supporting the CATO tender process. The most appropriate way to ensure that the widest range of opportunities are captured by the CATO model would be one that provides an independent and conflicts-free assessment of the projects to tender and tender criteria.

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?

    The SO and TOs should be subject to statutory obligations for undertaking preliminary works and should be adequately remunerated for all preliminary works undertaken for the tendered projects through an independently verified cost assessment process. We do not feel a success fee or any additional incentive would be necessary or appropriate in addition to a statutory obligation (eg in their licence).

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

    CATOs should pay for the preliminary works at the point of transfer, which should be independently assessed and included in the asset value to be measured against the £100m minimum value threshold.

Responses to questions set out in Chapter Three:

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 generally view the late CATO model as the preferred tender model that will generate the most interest from investors at the beginning of the CATO scheme. The basis of bids is largely in line with our expectation, and we are supportive of the approach for fixed price with limited number of reopeners for changes outside of the CATO's control. Risks associated with early development stage of the projects are less suitable for CATO to manage during construction in this model. The more developed the projects are at the time of tendering, the broader range of investors they will attract to maximise competitive tension.

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 are generally supportive of the early CATO model, and agree with OFGEM's view that it may be more appropriate for the market once the late CATO model is first *established and proven to be successful in attracting sufficient market interest. Cost uncertainty after the tender may be best managed with a cost assessment process, where clear provisions govern the determination of allowed and disallowed costs based on new information made available following the tender and actual progress of works.*

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

   In principle, we hold the view that the procurement criteria for tendered projects using HVDC technology should be the same as for other technology and hence it should be verified by an independent technical advisor to ensure appropriate risk allocation as for other projects.

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 that the late CATO model should be prioritised given it presents a more straightforward risk allocation which is currently better understood and manageable by some investors.

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

   From a tendering perspective we believe that with an appropriate risk allocation there will be sufficient interest to ensure that a successful CATO will emerge at the end of the process. With respect to the CATO's deliverability during construction and its ongoing operating performance, we believe the risk of a CATO failing to deliver would be low but in this unlikely case, a "CATO of last resort"-type mechanism could be effective for mitigating the risk of CATO not being in place.

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 view the proposed 25-year revenue period as suitable. In our view the length of the revenue entitlement period can be further extended to 30 years without introducing significant uncertainties over the project's ability to secure long term financing. Given that the asset recovery period is 45 years, there will be a residual value remaining at the end of revenue period. It is therefore important for investors to understand with certainty how this residual value will be set. Variable O&M costs over the long term are by no means a necessary investment criterion for many investors, and therefore should not be used as the primary criteria for determining the optimal length of the revenue period.

   We do not have a preference for CPI or RPI indexation. We believe a refinancing gain share mechanism where the gains are shared 50/50 is acceptable. With respect to net asset investment, we hold the view that it can be enabled as long as the amount is predetermined and limited to a certain maximum threshold.

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.

The proposed package of financial incentives for CATOs is generally acceptable. An availability-based incentive system is appropriate to ensure operations with a 'whole network' view, provided that boundary points are sensibly defined and that the availability can be measured in a transparent manner. We view 10% as the maximum adequate threshold for limiting CATO's annual revenue exposure given the risk profile including capital expenditures. 'Payment on completion' would be appropriate to incentivise timely asset delivery and no additional incentives/penalties would be required in our view.

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

Based on our review of the proposed CATO mechanisms we currently do not envisage any additional incentives to be required.

Responses to questions set out in Chapter Four:

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

We have not identified any additional risk or conflict of interest but would like to re-iterate the need for having an independent and conflicts-free evaluation process for determining the assets suitable for tender.

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

We have not identified any additional risk or conflicts of interest arising from the participation of incumbent onshore TOs.

3. Are there any additional conflicts of interest that we haven't identified?

We have not identified any additional conflicts of interest.

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?

In order to mitigate the conflict of interest, clear separability of SO activities would be beneficial. Ring-fenced ownership or governance arrangements with independent directors are examples of additional conflict mitigation measure required if the SO takes on a broader role in supporting the CATO competition.

We would be delighted to discuss these thoughts in an open and constructive manner with Ofgem.

Yours faithfully
On behalf of Macquarie Capital (Europe) Limited

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Elise Vaudour
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