OFGEM Consultation:

Extending Competition in Electricity Transmission: Arrangements to introduce onshore tenders

A Response by the Pensions Infrastructure Platform (PiP)

January 2016

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Executive Summary

The issue of pension funds' investment in infrastructure cannot be looked at in isolation from the wider economy and, specifically, the role of defined benefit (DB) pension provision. Despite the gradual decline of DB pension provision in recent years, over a third of the UK's workforce is still accruing benefits in a DB scheme, with schemes themselves managing over £900bn of assets. It is therefore crucial that employers sponsoring DB schemes can meet their obligations to scheme members without facing undue impact on their ability to invest elsewhere in the economy.

In order to match their long term pension payment obligations, provide security for scheme members and reduce the risk of volatile cash contributions from scheme sponsors, pension schemes need investments that generate long term, consistent, low-risk, inflation-linked cash flow returns. Core infrastructure, including electricity generation, distribution, storage and supply, can be a great source of these long term, low risk cash flows. Unlocking institutional investment into infrastructure on a large scale would also be highly beneficial to the economy.

However, achieving increased investment into infrastructure depends a great deal on the predictability of the returns that will be generated over the longer term. For the energy sector, and electricity in particular, this predictability principally relates to the political and regulatory regimes energy projects will be operating under, applicability of any investment incentives or subsidies that may be paid and the revenue that will be obtainable for any electricity produced, transmitted, stored or distributed.

Predictability in these areas is needed from start to finish – from the initial stages of project consideration – to make it worthwhile for pension schemes to incur project development and bidding costs and to arrange long term funding – right through to the asset or plant operation.

Any reduction in long term predictability, whether real or perceived, increases the overall project risk for an investor, pushes up the level of returns required to reward the taking of that risk and therefore makes projects more expensive.

As the sector's regulator, OFGEM has a significant influence in the perceived stability and predictability of the overall operating environment for energy related projects, and of their total lifetime cost and as such PiP welcome the ongoing consultation that is currently being undertaken in relation to the proposed competitively appointed transmission owners regime ("CATOs").

We believe that the proposal to tender for new, separable and high value onshore electricity transmission assets is an extremely interesting infrastructure development and once that, structured correctly could be of significant interest to UK pension schemes as they increasingly look to find suitable alternative investment propositions in the UK.

From the documents released to date whilst we are encouraged that the framework to create a suitable structure for pension schemes to invest (as either equity or debt) are being put in place we remain concerned that the current proposed approach to the commencement of any revenue streams will not commence until the operational start date will render this potential new asset class of little interest to the UK pension schemes for the foreseeable future.

Coming on the back of the success of the recent Thames Tideway ("TTT") financing, where PiP was instrumental in raising some £370m of UK pension scheme investment, it would be a major disappointment if the lessons learnt within this structure could not be used to develop a new form of hybrid solution that align your objectives of incentivising completion with the need of the pension schemes with a form of investment liquidity during the construction phase to ensure that they are able to perform their primary function of meeting regular pension payments efficiently.

If a favourable solution for pension schemes to the construction period income issue can be catered for by OFGEM, PIP are confident that commercial solutions can be found with the system operators and construction industry that would ensure the construction period risk is mitigated significantly to ensure a competitive cost of capital can be provided by the mostly likely ultimate long term holders of these assets. Suitable penalty regimes structured around normal liquidated damages regimes would equally provide sufficient incentives to ensure timely completion of the assets.

Overview of PiP Response

Introduction

1. The Pensions Infrastructure Platform ("PiP") is the UK infrastructure investment business set up "by pension funds for pension funds". Its objective is to facilitate investment into UK infrastructure projects by UK pension schemes, by developing investment vehicles which meet their needs in terms of structure, returns and cost.

2. PiP was established in 2012 following the signing of a Memorandum of Understanding by the National Association of Pension Funds ("NAPF"), the Pension Protection Fund ("PPF") and HM Treasury. The development was supported by 10 of the UK's largest defined benefit pension schemes.

3. PiP's first investment fund was launched in 2014. It is managed by Dalmore Capital and invests in PPP equity. The second fund invests in small scale (sub 5MW) rooftop solar PV installations. This was launched in February 2015 and is managed by Aviva Investors.

4. PiP has also worked with Dalmore on the successful consortium bid to construct and operate the new Thames Tideway Tunnel (TTT). PiP was instrumental in £370m of equity contribution to the project by UK pension schemes.

5. Since its establishment, PiP has helped secure over £1bn of committed investment into UK infrastructure projects.

6. PiP has recently received FCA authorisation. Future pension scheme investments into infrastructure will be delivered through a regulated investment fund, operated and managed by PiP.

7. PP will not be commenting on all of the questions posed in the Consultation request. As a specialist equity and debt financier, working on behalf of UK pension schemes to facilitate, source and manage effective investment by them into UK infrastructure projects we have limited our response to the key headline issues that would affect our overall level of interest in any financing proposition. We do this because we believe the stable long term, inflation linked cash flows that can be generated by core UK infrastructure projects is a good match for the long term pension payment liabilities within such schemes. This makes decision making easy for PiP because there is one fundamental criteria above all else that determines whether pension schemes will invest into infrastructure; will the entry price, the risk taken on and the returns to be generated over the full project life improve the ability of pension schemes to pay their members pensions in full when they become due?

   If these criteria are not met, there will be no investment since it would breach the basic fiduciary duty of the Trustees who are responsible for the financial security of the schemes they manage. No amount of political expediency, publicity or perceived "national interest" will overcome this basic requirement to safeguard the retirement provision for UK pension scheme members.

Background

8. When pension schemes assess investment into long term, illiquid assets, such as physical energy related projects, which typically will be bought and held for 20-50 years, a key consideration is the stability of the operating regime and therefore the robustness of the long term financial forecasts which need to be made. Political, regulatory, legal and subsidy environments are core parts of this stability assessment.

9. The perceived stability and predictability of the UK are real competitive advantages. Indeed, the reason why the UK has been so successful to date at attracting pension scheme investors into infrastructure projects is because it is viewed as having a very stable political, legal and regulatory environment. It is impossible to look forward to the potential for any future infrastructure investment projects without stating the essential precondition that the CATO regime should be established in a way that would mitigate any potential for any retrospective legislation that would subsequently change legal contracts that have been freely entered into. Any such legislation would undermine the stability argument and severely damage long term investor confidence.

10. Where a system of regulated or subsidy payments forms a significant part of the operational economics of a project, it is equally important that these are predictable for the long term. This applies through the full project life from the earliest stages of investment appraisal, while funding sources are being secured and after project contracts have been signed.

11. Pension schemes have a fundamental obligation to pay accrued pension benefits to members, usually on a monthly basis. It is therefore vitally important that pension schemes have a reliable stream of income from their investment portfolios to enable them to fund their pension payments. This need for income imposes a finite limit to the proportion of every scheme's investment portfolio that can be invested into non-yielding assets, such as infrastructure projects which do not return any cash to investors during a construction period. In general, the longer the period of no income, the less attractive an asset is for pension schemes to invest in.

    The current Ofgem proposals for the CATO's under which revenue payments to the onshore transmission asset owners will only begin upon completion of construction, which may be up to 5 years, will, all other things being equal, make these assets distinctly less attractive to pension schemes.

12. We now turn to the specific question posed by the consultation where our main concern lies with the current proposals.

Response to specific key question

Chapter 3, Question 6: What are your views on the proposed revenue package for CATO's? Do you have any views on the proposed duration of the revenue term, including how it relates to the asset cost 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?

Revenue Package

As currently proposed we are broadly comfortable with the 25 year proposal as it appears a sensible comprise to accommodate the various components required to provide certainty around the ability to secure the necessary longer term operational and maintenance contracts. Pension schemes would seek longer term investments where possible but would accept a 25 year investment.

The main area of concern that UK pension schemes have is that as currently envisaged this income stream will not commence until the asset becomes operational. As mentioned earlier this is not an attractive feature for pension schemes especially where there are potentially long construction periods.

We appreciate the desire to ensure construction is completed on time, but would suggest that there are a number of other ways to address this (penalty regimes, clawback of income, partial payment of any revenues (e.g. 50%)) which would then allow pension schemes to become directly involved in the assets during construction and thereby remove the "value shift" process that has become embedded in the UK PPP/PFI and Renewables market and which can also by its nature reduce the attractiveness of an asset given the potential distortion of the risk / reward profile.

The power of an approach that encouraged the ultimate long term holders of assets such as utility related assets, namely the pension schemes, in at day one was demonstrated by the recent TTT project where the end result was a highly attractive cost of capital for the overall project lifetime with limited leakage to third parties.

The lack of at least an element of income during construction periods will limit the number of UK pension schemes willing to invest to a very small number, which would be a poor outcome given HM Treasury's desire to see a greater involvement of UK pension schemes investing in UK infrastructure.

It should also be noted that in the OFTO regime, which forms a strong comparator for a number of the financing assumptions that have been made, there has to date been no OFTO build financing completed (all have been fully operational) and as such no parallels to the TRS model can be drawn for this element of the structure.

The development of the CATO regime provides OFGEM and the Government a significant opportunity to develop a financing regime that is highly attractive to the pools of capital (namely Pension Funds and Insurance companies) that given the regulatory environment surrounding Solvency II and Basel III are set to become the mainstream providers of the long dated capital required to fund these assets efficiently. We would request that when finalising the proposed regime the requirements of these investors are given strong consideration in addition to reflecting on how things have previously always been done.

Indexation

The ability to propose the percentage of total revenue streams that would be indexed has been used previously and seems a sensible proposition. Cash flows with an indexation link at either the equity or debt level is a very important consideration and this element should be retained.

We would also like to highlight the strong demand that exists within pension schemes for exposure to inflation linked debt instruments within the infrastructure sector will only continue to increase as more pension schemes develop their own capabilities to invest directly in assets which ultimately will benefit the overall cost of capital available for long term infrastructure projects.

Refinancing and Additional Investment

The refinancing concept is well understood and becoming an accepted part of funding structures, although with the increased use of institutional lenders to provide long term debt, they will require the provision of "make whole" provisions that will need to be accommodated in such refinancing provisions.

Commercially the concept of additional investments is appreciated and a suitable mechanism designed to allow these to be financed in such a way that does not incur the overall cost of the project by having additional capital commitment charges arising on contingent expenditure.

Further Information

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