VATTENFALL

James Norman
Ofgem
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Submitted via transmissioncompetition@ofgem.gov.uk

Dear Mr Norman,

Extending competition in electricity transmission: proposed arrangements to introduce onshore tenders

Vattenfall is the Swedish state-owned utility and one of Europe's largest generators of electricity and heat and the second largest player in the global offshore sector. It is our ambition to be at the forefront of the low carbon transition and we are strongly committed to significant growth in wind, onshore and offshore. This commitment and ambition is clearly evidenced by the fact that Vattenfall has invested nearly £3bn in the UK in onshore and offshore wind since 2008 and will have nearly 1GW in operation onshore and offshore by 2017. It is our ambition that the UK will continue to be a growth market for Vattenfall.

Thank you for the opportunity to respond to this consultation and we provide answers to relevant questions below. We look forward to engaging further with Ofgem on this and related matters. Please contact rob.driver@vattenfall.com if you would like to discuss.

Yours sincerely

Piers Guy
Director – Offshore Development, Vattenfall and UK Country Manager

Responses: Extending competition in electricity transmission: proposed arrangements to introduce onshore tenders

Chapter 2

Q5: 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 the late CATO build model, the SO and the incumbent TO are responsible for the preliminary works up to and including the consent application. The preliminary works include activities such as development of alternative siting and route options, environmental scoping and impact assessment, landowner negotiations, liaison with statutory consultees and other stakeholders, and dialogue with local communities. These activities inform key aspects of the consent submission itself, not least the proposed siting and routing of the new infrastructure. Competent management and execution of the preliminary works is vital if the consent submission is to stand any chance of success. In some cases, the selection of the proposed design may be a delicately balanced decision involving a trade-off between opposing criteria. Should a proposed transmission line be undergrounded where it passes through a designated landscape? This might improve the probability of securing consent, but it will also substantially increase the cost of implementing the consented design.

So, the conduct of the preliminary works not only determines the chances of a positive consent outcome; it also influences the scope and cost of the transmission works themselves. If "success" is defined in terms of a timely and positive consent decision then the incentive will tend to encourage decisions that minimise the consenting time and risk, potentially resulting in higher construction costs. Conversely, if success is defined in terms of construction costs then the incentive may tend to encourage decisions that minimise those costs but delay the consent application or increase the consent risk. If incentives are to be used, they should therefore be designed to reflect the complex and balanced nature of the decisions made during the development of the consent submission. Furthermore, any incentive mechanism should allow for customer choices, where relevant, during the development process (i.e. the customer may choose to pay one-off charges to facilitate alternative solutions that avoid, accelerate or de-risk the consenting process.

Although the SO and/or TO cannot guarantee a positive consent outcome, they are in a position to ensure that the consent submission is competent (as judged by the Planning Inspectorate or relevant planning authority). They are also in a position to ensure that the pre-submission activities are carried out in an efficient and timely way, so that the submission itself can be made according to a pre-agreed timescale. Finally, they are in a position to manage and account for the cost of the pre-submission activities. Licence obligations placed on the SO and/or TOs in relation to the management of preliminary works should focus on these three aspects.

Q6: Should CATOs pay for the preliminary works at the point of transfer?

In the late CATO build model, the appointed CATO 'adopts' the consent together with other outcomes from the package of preliminary works carried out by the SO and/orTO. The cost of those works must ultimately be recovered from Transmission Users according to the Use of System Charging Methodology in the event of completion of the works or from the relevant Contracted Parties through Cancellation Charges in the event of termination. Given that control of

the project is passed to the CATO at the "point of transfer" it would appear reasonable that the cost of the preliminary works is bundled up with the constructions costs and recovered by the CATO through the asset lifetime. We would therefore support the proposal that CATOs pay for the preliminary works at the point of transfer but note that this approach does not appear to deliver a more efficient outcome than an alternative mechanism in which the SO/TO recovers the same costs directly.

Chapter 3

Q1: 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?

The late tender model, as set out in the consultation document, offers a sensible means to achieve Ofgem's aim of extending competition in onshore transmission. The late tender approach offers three advantages which we consider to be important:

1. Responsibility for preliminary works remains with the SO and/or TO – Vattenfall's previous submission (letter dated 10/7/2015) sets out our thinking on this point.
2. Impact of tendering on overall delivery timescale is minimised, as the tender process runs in parallel with the consent application, examination process and the Secretary of State's decision.
3. The project scope is well-defined at the point of tender, which facilitates effective competition through the submission of fixed price bids.

With regard to the basis of bids, we broadly concur with Ofgem's initial views. The late tender model minimises bidders' scope uncertainty and price risk, and should enable them to submit fixed prices for construction and operation of the asset. Use of cost sharing and pass-through mechanisms should be strictly limited to those costs which the CATO is not in a position to control.

Q2: 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?

Vattenfall considers that the early tender model is inferior to the late tender model (see our response to Q1, above). For us, any potential advantages that might be delivered through 'innovation' are heavily outweighed by the likely disadvantages associated with the following factors:

1. Lack of project definition at the point of tendering
2. Long time period between tender submission and project execution
3. Additional risk associated with consenting process

In our view, these factors will render the tender process largely ineffective as a means of reducing costs to consumers. This is because bidders will be unwilling to submit bids on the basis of a fixed price – for obvious reasons. As the last part of the question indicates, cost uncertainty following the tender would have to be managed, suggesting some kind of regulatory compact between the CATO and Ofgem. The risks borne by customers in this scenario would be very similar to the risks they bear under the present arrangement (ie. with an incumbent TO building and owning the asset). Given the additional costs associated with the tender process and managing regulatory

relationships with multiple CATOs, it is far from clear that this approach will deliver overall cost reductions.

Q4: 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?

Vattenfall supports Ofgem's proposal to prioritise the late tender model for use in the first round of tendered projects. Moreover, we think that this model offers by far the best strategy for managing the cost of major transmission investments in the longer term. We do not envisage any circumstances where early CATO build could lead to better outcomes than late CATO build.

In the late tender model, the overall technical solution to the 'need case' is defined and chosen by the SO and/or TO as a key part of the preliminary works. In our view, these parties are well-placed to make these key decisions objectively with the long-term interests of customers in mind. Given the emphasis on managing transmission costs, we would expect that most projects will make use of conventional technologies that are well understood by the incumbent SO and TOs. However, it is important that the decision process should facilitate the adoption of innovative solutions where there is a clear advantage in doing so. The SO and TOs should be obliged/incentivised to achieve this by consulting external parties, such as technology providers and potential CATO bidders, during the process of needs assessment and solution development.

Q7: 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 that 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?

Vattenfall is not in a position to comment on the overall package of financial incentives for CATOs. However, we are interested in ensuring that generators and other system users are not disadvantaged as a result of under-performance of CATO-owned assets. Hence, our response focuses on the proposed performance incentive.

We support Ofgem's proposal to implement an availability-based incentive, to encourage CATOs to plan and manage the ongoing maintenance of their assets and minimise the impact of outages. In our view, this objective is not likely to be best served by treating all outages on the same basis. With proper co-ordination, planned outages of transmission assets can often be accommodated with little or no impact on the operation of the system; conversely, an unplanned outage occurring at an inconvenient time can have far-reaching and costly effects. Therefore, we would advocate an incentive arrangement that differentiates between planned and unplanned outages. More specifically:

- The target for 'planned unavailability' should be set at a level that facilitates planned maintenance of the assets in line with accepted industry practices, without incurring a penalty.
- The target for 'unplanned unavailability' should be set at zero – all unplanned outages should be penalised.
- The 'unit penalty' for exceeding the target level should be significantly higher for unplanned outages than for planned outages.

Also, we note that Ofgem is proposing a 10% cap on the revenue at risk in any year. While we recognise the benefits of such an arrangement with respect to securing finance, there is a danger that such a cap could result in a mis-match between the CATO's risk exposure and the actual system costs arising from an unplanned fault or failure of the asset. In some cases it could be more costly for the CATO to fund the necessary repair or replacement work than to accept the 10% revenue penalty for the remaining lifetime of the asset. Although the latter outcome might be commercially preferable to the CATO, it is unlikely to be optimal from a 'whole network' viewpoint.

In our view, there is a strong case for setting the 'revenue at risk' cap at a higher level, in order to avoid this type of scenario. A cap in the 25% to 50% range would provide a more appropriate reflection of wider costs for cases where the function of the asset is seriously impaired for an extended period. In any case, it would be sensible to set out a contingency plan under which the necessary repair work could be funded from elsewhere, if the CATO proved unwilling or unable to fund the work itself. This fall-back option would have to be revenue-neutral from the CATO's viewpoint, in order to avoid creating perverse incentives.