

# Update on competition in onshore electricity transmission

## Update

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### Overview:

This document sets out our views on the future of competition within onshore electricity transmission.

We set out the conclusion of our review of the criteria for competition, the process for applying the criteria to identify projects for delivery through the Special Purpose Vehicle (SPV) and Competition Proxy delivery models, and our updated view of those delivery models.

## Context

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The GB onshore electricity transmission network is currently planned, constructed, owned and operated by three transmission owners (TOs): National Grid Electricity Transmission (NGET) in England and Wales, SP Transmission in the south of Scotland, and Scottish Hydro Electric Transmission in the north of Scotland. We regulate these TOs through the RIIO (Revenue = Incentives + Innovation + Outputs) price control framework. For offshore transmission, we appoint offshore transmission owners (OFTOs) using competitive tenders.

The TOs are currently regulated under the RIIO-T1 price control, which runs for eight years until 2021. Under this price control, we developed a mechanism for managing the assessment of large and uncertain projects called 'Strategic Wider Works' (SWW). The TOs are funded to complete preconstruction works. Once the need for and costs of projects have become more certain, the TOs bring forward construction proposals and seek funding for them. As part of our decision on the RIIO-T1 price control, we set out that projects brought to us under the SWW regime could be subject to competition.

Following our decision on the RIIO-T1 price control, we undertook the Integrated Transmission Planning and Regulation (ITPR) project, which reviewed the arrangements for planning and delivering the onshore, offshore and cross-border electricity transmission networks in GB. Through this project we decided, among other decisions, to increase the role of competition where it can bring value to consumers.

Following the ITPR project, we set up the Extending Competition in Transmission (ECIT) project in early 2015 to introduce additional competition in the delivery of new, separable, and high value onshore electricity transmission investment. We have published a series of ECIT policy consultation and decision documents, which are available on our website. In December 2016 we published our first combined SWW and competition consultation for the North West Coast Connections project, and published an update to that consultation in July 2017.

In June 2017 we published an update on our plans to introduce competition to onshore electricity transmission, stating that we are deferring further development of the Competitively Appointed Transmission Owner (CATO) regime until the timing of the necessary legislation is more certain. We reiterated that we continue to consider that there are significant benefits to consumers in introducing competition into the delivery of *new, separable, and high value* onshore electricity transmission projects. In August 2017 we published a consultation on the Hinkley-Seabank project, setting out potential delivery models for the project in the absence of the necessary legislation for CATO.

## Associated documents

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Hinkley Seabank – Minded-to consultation on delivery model, January 2018  
<https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-minded-consultation-delivery-model>

Hinkley Seabank – Consultation on Final Needs Case and potential delivery models, August 2017  
<https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-consultation-final-needs-case-and-potential-delivery-models>

North West Coast Connections – Open letter update, July 2017  
<https://www.ofgem.gov.uk/publications-and-updates/update-our-assessment-north-west-coast-connections-project>

Update on Extending Competition in Transmission, June 2017  
[https://www.ofgem.gov.uk/system/files/docs/2017/06/update\\_on\\_extending\\_competition\\_in\\_transmission.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/06/update_on_extending_competition_in_transmission.pdf)

North West Coast Connections – Consultation on the project’s Initial Needs Case and suitability for tendering, December 2016  
<https://www.ofgem.gov.uk/publications-and-updates/north-west-coast-connections-consultation-project-s-initial-needs-case-and-suitability-tendering>

Extending competition in electricity transmission: arrangements to introduce onshore tenders, October 2015  
<https://www.ofgem.gov.uk/publications-and-updates/extending-competition-electricity-transmission-proposed-arrangements-introduce-onshore-tenders>

Criteria for onshore transmission competitive tendering, May 2015  
<https://www.ofgem.gov.uk/publications-and-updates/criteria-onshore-transmission-competitive-tendering>

Integrated Transmission Planning and Regulation project: Final Conclusions, March 2015  
<https://www.ofgem.gov.uk/publications-and-updates/integrated-transmission-planning-and-regulation-itpr-project-final-conclusions>

Strategic Wider Works Guidance, October 2013  
<https://www.ofgem.gov.uk/publications-and-updates/guidance-strategic-wider-works-arrangements-electricity-transmission-price-control-riio-t1-0>

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## Executive Summary

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This document:

- summarises the background to our work on introducing the benefits of competition into the delivery of onshore electricity transmission infrastructure;
- confirms, following our recent review, that we consider the current new, separable and high value criteria for competition remain appropriate;
- provides an update on the 'Special Purpose Vehicle' (SPV) and 'Competition Proxy' delivery models and sets out the indicative process for applying the criteria for competition to identify projects for delivery through these models; and
- explains our intention to consider the application of the SPV and Competition Proxy models for all future Strategic Wider Works (SWW) projects that meet the criteria for competition and are subject to a Needs Case assessment during RIIO-T1.

### Criteria for competition

We set out in our August 2017 consultation on Hinkley-Seabank our initial views on the appropriateness of the criteria for competition (new, separable, high value) in relation to two new proposed delivery models – the SPV and Competition Proxy models. Our initial view was that the criteria may be appropriate for the SPV model, but not all the criteria may be needed for the Competition Proxy model. We set out that we would undertake a review of the criteria for competition and consider any relevant responses to our consultation.

We have reviewed the objectives and definitions of the criteria in relation to both delivery models and considered the relevant consultation responses. **We have concluded that the current criteria remain appropriate for identifying projects suitable for delivery through both the SPV and Competition Proxy delivery models.** This is because while potentially fewer criteria are needed for the Competition Proxy model, there are benefits to applying the same criteria across the SPV and Competition Proxy models.

For the avoidance of doubt, we consider that the criteria continue to be relevant to the CATO delivery model. Once there is more certainty over the legislative timetable, we will consider the appropriateness of the CATO delivery model for projects that meet the criteria.

We intend to formalise the criteria for competition in guidance. Alongside this document, we have published a subsidiary document setting out a draft of the criteria for competition guidance, for consultation. We invite stakeholders to provide their views on the draft guidance. We intend to keep the criteria under review to ensure that they continue to produce favourable outcomes for consumers, for example as part of our development work on RIIO-2.

## Applying the criteria for competition and selecting delivery model

In this document we summarise the indicative processes for assessing SWW projects submitted to us during RIIO-T1 against the criteria for competition and indicating the appropriate delivery model for them. We have set out in Appendix 3 diagrams showing the proposed end-to-end processes for both the SPV and Competition Proxy models. We have not included detail on the SWW delivery model process as that is set out already in separately published guidance.<sup>1</sup>

Where an SWW project is submitted for an initial needs case, we will confirm at that stage whether the project meets the criteria for competition and if so, which delivery model is the most appropriate. Where an SWW project is not submitted for an initial needs case, we will confirm at the final needs case stage whether the project meets the criteria for competition and if so, which delivery model is the most appropriate.

We also set out further detail on arrangements after our delivery model decision and note how these will vary depending on the delivery model we choose.

### Delivery models

In our August 2017 consultation on Hinkley-Seabank we provided initial information on the regulatory structure of the SPV and Competition Proxy delivery models. The analysis underpinning our January 2018 minded-to consultation on the delivery model for the Hinkley-Seabank project (published alongside this document)<sup>2</sup> shows that the savings we expect both these models to deliver, if run appropriately, are not limited to just that project. **We confirm, therefore, that we intend to consider the Competition Proxy and SPV delivery models for all future SWW projects that are subject to a needs case assessment during RIIO-T1.** We will do so only where a project meets the criteria for competition, and will consider the status quo SWW RIIO delivery arrangements alongside the Competition Proxy and SPV delivery models.

In this document we set out our updated positions on Competition Proxy and SPV delivery models.

#### *Competition Proxy model*

Our January 2018 minded-to consultation on the delivery model for the Hinkley-Seabank project sets out in Chapter 4 the way in which we envisage the Competition Proxy model being implemented and operated for that project. We welcome responses to that consultation. We set out in this document that we may consider any specific differences in the model's application based on the specifics of the project being assessed (eg duration of construction period).

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<sup>1</sup> <https://www.ofgem.gov.uk/publications-and-updates/guidance-strategic-wider-works-arrangements-electricity-transmission-price-control-riio-t1-0>

<sup>2</sup> <https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-minded-consultation-delivery-model>

*SPV model*

In order to maximise the benefits of the SPV model, we intend to take additional steps to set out an efficient allocation of risk across the Transmission Owner (TO), SPV and consumers, and to ensure a fair, transparent and efficient SPV competition process. In particular, we intend to consider:

- the most effective incentives and obligations for a TO to deliver an efficient competition;
- the efficient allocation of risks, in general, across the SPV, the TO, and consumers;
- the regulatory arrangements underpinning the model, as well as the scope and key parameters of the competitive tender for the SPV; and
- how our processes for decision-making can ensure timely delivery of a project through the SPV model.

By way of broad outline of our next steps on the SPV model, through early 2018 we expect to publish:

- Further proposals on TO incentives and obligations;
- Guidance on SPV/TO contract principles and risk allocation;
- Further details on the regulatory model;
- Detail on the SPV tender process and evaluation requirements; and
- Proposed changes to the TO licences to support future implementation of the SPV model.

# 1. Introduction

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## This document

- 1.1. This document summarises the background to our work on introducing the benefits of competition into the delivery of onshore electricity transmission infrastructure, provides an update on our views on the future of competition in onshore electricity transmission, and our views on specific policy points following our consultation on the Hinkley-Seabank (HSB) project in August 2017 ("HSB consultation"). It also:
- explains the outcome of our recent review of the criteria for competition (we confirm that the criteria remain appropriate) and sets out our process for applying the criteria to identify projects for delivery through the 'SPV' and 'Competition Proxy' models;
  - provides an update on the SPV and Competition Proxy delivery models; and
  - explains our intention to consider the application of the SPV and Competition Proxy models for all future Strategic Wider Works (SWW) projects that meet the criteria for competition and are subject to a Needs Case assessment during RIIO-T1.
- 1.2. Alongside this update, we have published three related documents:
- a decision on the Needs Case for the HSB project;
  - a consultation on our minded-to position that the Competition Proxy model should be applied to the delivery of the HSB project. That document also sets out our proposals for how we envisage the Competition Proxy model being implemented and operated for that project;<sup>3</sup> and
  - a consultation on changes to the System Operator's Standard Licence Condition (SLC) C27 to implement system planning processes (via the annual Network Options Assessment (NOA)) for identifying projects that meet the criteria for competition.<sup>4</sup>
- 1.3. This document is intended, in combination with the documents referred to above, to explain how we propose to identify projects suitable for CATO or SPV competition or delivery through the Competition Proxy model. It also explains the delivery models that we may apply to projects so identified.

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<sup>3</sup> We invite interested stakeholders to respond to this consultation through the details specified in that consultation on our website: <https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-minded-consultation-delivery-model>

<sup>4</sup> This proposes to amend SLC C27 to reflect previous policy decisions on the role of the SO in providing its assessment of projects identified in the annual NOA report against the criteria for competition. We invite interested parties to respond in line with the details specified in that consultation on our website: <https://www.ofgem.gov.uk/publications-and-updates/consultation-changes-licence-condition-c27>

## 2. Background summary and update on the future of competition in onshore electricity transmission

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### Chapter Summary

This chapter sets out an overview of the regulatory frameworks currently in place for Transmission Owners, and the background to our introduction of the benefits of competition into onshore electricity transmission.

### General framework and our role

- 2.1. As part of our role to protect the interests of existing and future electricity consumers, we work to ensure that the revenues of natural monopolies, such as onshore electricity Transmission Owners (TOs), reflect efficient delivery of their obligations.
- 2.2. TO revenues are traditionally set through price controls. Price controls set the amount of money that a TO can recover from consumers for the delivery of its required outputs and other obligations. The current price control, RIIO-T1, is the framework that sets the TOs' revenues for the period covering 1 April 2013 – 31 March 2021.
- 2.3. As part of RIIO-T1 we created the 'Strategic Wider Works' mechanism (SWW). This mechanism allows TOs to deliver additional large electricity transmission projects not accounted for in the original RIIO-T1 settlement due to uncertainties with need, timing, design and overall cost at the time RIIO-T1 was set.<sup>5</sup>

### Development of competition in onshore transmission

- 2.4. Promoting competition can help deliver better outcomes for consumers. For example, we have seen significant savings in the delivery of offshore electricity transmission infrastructure. This has been achieved through competitive tenders for ownership and operation of offshore transmission assets, through our Offshore Transmission Owner (OFTO) regime.<sup>6</sup>

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<sup>5</sup> More information on the SWW framework is in the SWW Guidance: <https://www.ofgem.gov.uk/publications-and-updates/guidance-strategic-wider-works-arrangements-electricity-transmission-price-control-riio-t1-0>

<sup>6</sup> Tender Round 1 savings are estimated to be between £200-400m. TR2 and TR3 savings are estimated to be between £680-1,100m: [https://www.ofgem.gov.uk/sites/default/files/docs/2014/05/140508\\_covering\\_letter\\_to\\_ce](https://www.ofgem.gov.uk/sites/default/files/docs/2014/05/140508_covering_letter_to_ce)

- 2.5. We set out at RIIO-T1 Final Proposals that projects brought forward by TOs under the SWW framework could be subject to a competitive process.
- 2.6. Subsequently, we undertook the Integrated Transmission Planning and Regulation (ITPR) project.<sup>7</sup> Amongst other considerations, ITPR reviewed the arrangements for planning and delivering the onshore electricity transmission networks in GB. In our March 2015 ITPR Final Conclusions, we decided to increase the role of competition where it can bring value to consumers.
- 2.7. We set up the Extending Competition in Transmission (ECIT) project in early 2015 to implement the ITPR conclusions on competition. In May 2015<sup>8</sup> we decided to seek to introduce additional competition into the delivery of onshore electricity transmission investments that are new, separable, and high value (our "criteria for competition"). Through 2015 and 2016 we developed the definitions of those criteria for competition. We also developed the policy and processes to run competitive tenders for a Competitively Appointed Transmission Owner (CATO).
- 2.8. We have been working with Government to introduce legislation which is needed to enable the CATO regime. In June 2017 we published an update on this work. This update noted that an opportunity to introduce the required legislation looks unlikely in the immediate future and that we have paused our work on the CATO regime.
- 2.9. We remain committed to working with Government to seek an appropriate opportunity to introduce the legislative change necessary to implement the CATO regime. We may, once the timing of the necessary legislation is clearer, take forward further development of the CATO regime.

### **Alternatives to the CATO delivery model**

- 2.10. In the context of uncertainty around when the legislation necessary for CATO would be enacted, we considered recently alternative ways in which we can protect the interests of existing and future consumers by implementing competition in onshore electricity transmission or seeking to replicate its effects.
- 2.11. In August 2017, we published our HSB consultation, which gave our views on two areas. Firstly, it set out our views on the needs case for the HSB project. Secondly, it set out two alternative delivery models that would

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[pa\\_report\\_final\\_for\\_publication.pdf](#), and [https://www.ofgem.gov.uk/system/files/docs/2016/03/ofgem\\_tr2\\_tr3\\_evaluation\\_final\\_report.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/03/ofgem_tr2_tr3_evaluation_final_report.pdf)

<sup>7</sup> <https://www.ofgem.gov.uk/publications-and-updates/integrated-transmission-planning-and-regulation-itpr-project-final-conclusions>

<sup>8</sup> <https://www.ofgem.gov.uk/publications-and-updates/criteria-onshore-transmission-competitive-tendering>

benefit consumers and that we considered could be implemented for HSB: the Special Purpose Vehicle (SPV) and the Competition Proxy models.

- 2.12. We received 31 responses to our August consultation on HSB.<sup>9</sup> These were from a mix of local stakeholders, incumbent network operators, and interested parties across the construction and finance industries. Appendix 3 of the January 2018 HSB minded-to consultation contains a summary of those responses. We discuss respondents' views in Chapters 3 and 5 of this document where relevant.
- 2.13. In the January 2018 HSB minded-to consultation on the delivery model for the HSB project, we set out why we consider Competition Proxy is the most appropriate model to deliver the HSB project, and describe more detail on the model. We provide a high level summary of the Competition Proxy model in this document, and have also set out more detail on the SPV model in Chapter 5 of this document.

## Projects we expect to consider

- 2.14. We have published on our website a list of current and future potential projects.<sup>10</sup> We will update this list as and when new projects are submitted to us for consideration, or where future Networks Options Assessments published by the System Operator indicate any potential new projects.

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<sup>9</sup> The non-confidential responses are available on our website:  
<https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-consultation-final-needs-case-and-potential-delivery-models>

<sup>10</sup> <https://www.ofgem.gov.uk/electricity/transmission-networks/critical-investments/strategic-wider-works>

## 3. Criteria for competition

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### Chapter Summary

This chapter describes why we consider that the current criteria for competition remain appropriate for both the Competition Proxy and SPV delivery models. It also sets out how we intend to formalise these criteria for clear and consistent future use.

### Background

- 3.1. As referred to in the previous chapter, one of the conclusions from our ITPR project in 2015 was that it is in consumers' interests to extend the use of competition to onshore electricity transmission assets that are new, separable, and high value. Our view was that tendering onshore assets that are new, separable, and high value means that benefits from tendering such as cost savings and innovation will outweigh the administrative and interface costs of competition.
- 3.2. Following consultation, we published draft definitions of the new, separable, and high value criteria for competition in November 2016.<sup>11</sup> We have also previously published impact assessments supporting our view on the benefits of introducing competition for new, separable, and high value onshore electricity transmission assets.
- 3.3. The definitions of the criteria we set out in November 2016 are:
  - **New** – a completely new transmission asset or a complete replacement of an existing transmission asset.
  - **Separable** – the boundaries of ownership between these assets and other (existing) assets can be clearly delineated.<sup>12</sup>
  - **High value** – a threshold set at £100m of expected capital expenditure of a project at the point of our initial assessment of whether the project should be subject to competition.<sup>13</sup>

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<sup>11</sup> <https://www.ofgem.gov.uk/publications-and-updates/extending-competition-electricity-transmission-decision-criteria-pre-tender-and-conflict-mitigation-arrangements>

<sup>12</sup> Transmission assets do not need to be electrically contiguous or electrically separable from other assets to be considered separable. However, the SO may on a case-by-case basis propose electrical separability at project interfaces, if the SO considers there is a cost-benefit justification for this.

<sup>13</sup> The £100m threshold will be a fixed nominal value and not indexed to a reference year, and assessed in the price base of the year of the assessment.

## Criteria review

- 3.4. The criteria, and their underlying objectives, were developed with the running of a competition to appoint a CATO licensee in mind. In our August 2017 consultation on HSB, we set out, therefore, that we would review the criteria for competition to determine whether they remain appropriate for the SPV model and Competition Proxy model. We also set out our initial findings. We suggested that the criteria appeared completely appropriate for the SPV model, but that the new and separable criteria may not be required for the Competition Proxy model.
- 3.5. We asked stakeholders whether they agreed with our initial findings and whether the criteria should be the same for all models. Stakeholders generally agreed that the criteria are appropriate for the SPV model. We received mixed views on the relevance of the criteria for the Competition Proxy model. A summary of stakeholder responses is in Appendix 1.

## Our view

- 3.6. Tables A2.1 and A2.2, in Appendix 2, show our assessment of the relevance of the objectives of each criterion (which were set out in May 2015) in relation to the SPV and Competition Proxy models respectively. In summary, we consider that:
- **SPV Model** – the existing criteria are wholly appropriate.
  - **Competition Proxy Model** – while potentially fewer criteria are needed, there are benefits from applying the existing criteria:
    - (a) increased regulatory certainty and consistency on identifying which projects are suitable for the delivery models;
    - (b) better alignment with cost benchmarks from similar project types (eg OFTOs, Interconnectors); and
    - (c) ease of delineating Competition Proxy assets from assets under current and future price controls.
- 3.7. **Our view is therefore that the current new, separable and high value criteria remain appropriate for identifying projects suitable for delivery through both the SPV and Competition Proxy delivery models.** This will ensure that projects are identified clearly and consistently. For the avoidance of doubt, we consider that the criteria continue to be relevant to consideration of the CATO regime. Once there is more certainty over the legislative timetable, we will consider the appropriateness of the CATO regime for projects that meet the criteria.

## Next steps on the criteria

- 3.8. We intend to formalise the criteria for competition in a guidance document. Alongside this document, we have published a subsidiary document setting out a draft of the criteria for competition guidance, for consultation. We invite stakeholders' to provide their views on the draft guidance. Stakeholders can respond directly to [NTIMailbox@ofgem.gov.uk](mailto:NTIMailbox@ofgem.gov.uk), or as part of our SLC C27 consultation open until 20<sup>th</sup> February 2018 and published on our website.
- 3.9. We intend to balance the benefits of maintaining consistency in the competition criteria with the need to keep the criteria under review to ensure that they continue to produce favourable outcomes for consumers. As discussed later in Chapter 5, we are continuing our work on the scope of competition for RIIO-2, and we may review the criteria for that purpose; however, we do not intend to review the criteria before our proposals for RIIO-2 are further developed.
- 3.10. We previously intended to place the criteria into secondary legislation as part of the broader legislative package that was required to enable CATO. Legislation is not required to enable the SPV model or Competition Proxy model and it is not necessary to place the criteria in secondary legislation. If the necessary CATO legislation subsequently comes forward, we will work with Government to consider the most appropriate way to align the criteria with the CATO legislation.

## 4. End-to-end process for delivery models

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### Chapter Summary

This chapter summarises the end-to-end processes we propose to use when considering which delivery model is appropriate for delivering a particular project. We set this out for the SPV and Competition Proxy models.

### Process

- 4.1. In our November 2016 decision document, we set out our processes for applying the criteria for competition, and for deciding whether a project should be subject to competition. This included how these processes relate to the Initial Needs Case (INC) and Final Needs Case (FNC) stages we apply to eligible SWW projects.<sup>14</sup>
- 4.2. We have reviewed the appropriateness of these processes to the SPV and Competition Proxy models and have summarised below how we propose the criteria assessment and delivery model processes would work. The detailed processes for the Competition Proxy model we have set out in this document and in the January 2018 HSB minded-to consultation (published alongside this document), may be seen as broadly representative of the processes which we would envisage applying to other projects delivered through that model, though we note that the latter is subject to consultation and may change. The processes for the SPV model set out in this Chapter should be viewed as more indicative at this stage. We set out in Chapter 5 our expected further work on the SPV model.

### Process for decision-making

- 4.3. We have set out in Appendix 3 the indicative end-to-end process for integrating the application of the criteria with the existing SWW mechanism.
- 4.4. This process distinguishes between our approach for future projects, where we anticipate that these projects will always submit an INC, and our approach to projects without an INC stage. The latter relates to circumstances where it is more appropriate to progress a project straight to an FNC, such that it is not subject to our recently introduced INC assessment under SWW. HSB is an example of a project for which there has not been an INC.

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<sup>14</sup> <https://www.ofgem.gov.uk/publications-and-updates/guidance-strategic-wider-works-arrangements-electricity-transmission-price-control-riio-t1-0>

- 4.5. The diagrams in Appendix 3 set out the process under both the approaches described above, for both the SPV and Competition Proxy models. We have included the process for projects delivered through SWW as a point of comparison.<sup>15</sup>

### **Approach for projects with an INC**

- 4.6. Figure A3.1 in Appendix 3 sets out in a flowchart the end-to-end process for a project brought to us where that project will be subject to both an INC and a FNC stage assessment.

#### *INC stage*

- 4.7. At the INC stage we will, in summary, consider:
- Whether the project is likely to be needed (in line with our SWW guidance);
  - Whether the design of the project is suitably justified (in line with our SWW guidance);
  - Whether the project, in whole or in part, meets the criteria for competition;
  - In considering the points above, whether to apply our principles for bundling, splitting, and re-packaging projects; and
  - If the project (or a part of the project) meets the criteria for competition, which of the delivery models is the most appropriate to deliver the project (or part of the project).
- 4.8. As we are proposing no changes to the criteria for competition, we consider that our principles for bundling, splitting, and re-packaging projects, as previously consulted on and confirmed in our November 2016 consultation, remain appropriate. We have included these principles in Appendix 4 for completeness.
- 4.9. Following a public consultation on our initial needs case assessment we will publish our initial views on the areas covered by our assessment. Alongside our views on the initial needs case assessment, we will also set out our views on our assessment of the project against the criteria for competition and the delivery model pathway the project will follow.

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<sup>15</sup> Full details of the process for projects delivered through SWW are available in the SWW Guidance, published on our website.

*FNC and project costing stages*

- 4.10. The FNC and project costing stages come after the INC stage. The process will be different for the SPV and Competition Proxy models.
- 4.11. **Under the SPV model** we would expect the TO to develop early drafts of documentation and arrangements to support the future SPV tender (eg a draft proposed TO/SPV delivery agreement) before the FNC stage. At the FNC stage, we would confirm whether there is a need for the project through our usual consultation and decision processes as set out in the SWW guidance. We would also in parallel review the documentation and arrangements to support the future SPV tender. Following our decision on the FNC, the TO would run the SPV tender on the specified terms. Following the outcome of the SPV tender we would make changes to the TO's licence as appropriate to give effect to the project-specific arrangements set out in the SPV/TO delivery agreement. As set out in Chapter 5, we will be further developing the detail and processes for the SPV model in early 2018.
- 4.12. **Under the Competition Proxy model**, we expect the process at the FNC stage to be broadly similar to that undertaken under the current SWW arrangements, as set out in the SWW Guidance. After the consultation and confirmation of need at the FNC stage, the project will move into the project costing stage where we will assess the project costs and determine an indicative project-specific revenue stream. We would then make changes to the TO's licence as appropriate to give effect to the determined project-specific revenue. Further information on the process for the Competition Proxy model is available as a part of the January 2018 HSB minded-to consultation published alongside this document.

**Approach for projects without an INC**

- 4.13. Figure A3.2 in Appendix 3 sets out the end-to-end process for projects without an INC, for example where a project has sufficiently advanced beyond the planning stage.
- 4.14. At the FNC stage we would confirm the need for the project and the suitability of the design of the project through our usual consultation and decision processes as set out in the SWW guidance. We would also in parallel undertake an assessment of, and consult on:
- Whether the project, in whole or in part, meets the criteria for competition;
  - In considering the points above, whether to apply our principles for bundling, splitting, and re-packaging projects;<sup>16</sup> and

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<sup>16</sup> As we are proposing no changes to the criteria for competition, we consider that our



## Update on competition in onshore electricity transmission

- If the project (or a part of the project) meets the criteria for competition, which of the delivery models is the most appropriate to deliver the project (or part of the project).
- 4.15. At the conclusion of the FNC stage, we will confirm our assessment of the project against the criteria for competition, and make a decision on the delivery model pathway the project will follow.
- 4.16. **Under the Competition Proxy model** the project costing stage will be the same as the approach set out in 4.12.
- 4.17. **Under the SPV model**, the TO will be required to undertake the activities it would have undertaken after an INC stage under the approach set out in 4.11, ie activities to prepare for an SPV tender. Once those activities have been completed, the TO would run the SPV tender on the specified terms. Following the outcome of the tender we would make changes to the TO's licence as appropriate to give effect to the project-specific arrangements set out in the SPV/TO delivery agreement.

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principles for bundling, splitting, and re-packaging projects, as previously consulted on and confirmed in our November 2016 consultation, remain appropriate.

## 5. SPV and Competition Proxy delivery models

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### Chapter Summary

This chapter summarises the two alternative (to CATO) delivery models first set out in our August 2017 HSB consultation, along with a description of responses to the consultation. It provides detail on the next steps we will undertake to develop the SPV model further. It sets out that information on further development of the Competition Proxy model is provided in the January 2018 HSB minded-to consultation published alongside this document.

### August HSB consultation

- 5.1. In our August 2017 HSB consultation, we set out our views on the SPV and Competition Proxy delivery models for future projects that meet the criteria for competition. We set out that these could deliver a significant proportion of the benefits of a CATO tender, in light of the pause to the development of the CATO regime.
- 5.2. The majority of responses to the HSB consultation explicitly discussed the SPV and Competition Proxy delivery models. We consider these responses, and include a summary of them, in the January 2018 HSB minded-to consultation published alongside this document. We also set out a brief high level summary of the responses below.
- 5.3. Respondents generally accepted that Competition Proxy would provide some consumer benefit relative to SWW and that it presented less of a risk to the construction timetable than the SPV model. However, around half of respondents felt that the Competition Proxy model would not be able to offer the same benefits for consumers as the SPV model because retaining delivery through the TO would result in higher costs of debt and equity, and less innovation in construction and contracting.
- 5.4. The SPV model was very well received by potential bidders with many respondents agreeing that the model could provide significant benefits for consumers as a result of access to lower costs of debt and equity, likely innovation in construction and contracting, and a longer revenue term. A couple of respondents caveated this by stating that the benefits provided by an SPV would be inferior to those that a full CATO competition could elicit. The majority of respondents flagged that risk allocation will form a key part of the contractual and regulatory arrangements and indicated that further consideration needed to be given to this. A key concern from bidders was the extent to which NGET, as an insufficiently incentivised party, would play a central role in the development of the SPV model. NGET in particular highlighted that the SPV model inherently carried a series of complex and unclear accountabilities which would be hard to regulate and hence detrimental to consumers.

- 5.5. We summarise our updated positions on the Competition Proxy and SPV models below. This should be read in conjunction with Appendix 3, which sets out the end-to-end processes for each of the delivery models.

### Competition Proxy model

- 5.6. Under the Competition Proxy model we would set the TO's allowed revenue for a project in line with the outcome we consider would have resulted from an efficient competition for construction, financing and operation of the project. We would fix this revenue for a defined period (in general we consider 25 years is likely to be appropriate). The revenue would be based on our determination of a project-specific cost of capital for the construction and operational periods of the revenue term and our determination of efficient costs for construction and operations of the project.
- 5.7. We consider that the cost benefit analysis within Chapter 3 of the January 2018 HSB minded-to consultation demonstrates that the Competition Proxy model is capable of delivering significant consumer benefit for HSB. We also see no reason why the Competition Proxy model couldn't deliver comparable benefits for any new, separable, and high value transmission project, given that the benefits derive from factors that are not unique to HSB. We note however that we would need to consider whether there should be any divergence from the approach to implement the Competition Proxy model proposed for HSB depending on the characteristics of the specific project being considered. For example, based on the risk profile of the specific project, we could consider different regulatory arrangements to that which we may apply to HSB. Where we propose a different approach to that proposed for HSB in the January 2018 HSB minded-to consultation, we would set out our view on the consumer benefits case.
- 5.8. More information on the Competition Proxy model is set out in the January 2018 HSB minded-to consultation published alongside this document.

### SPV Model

- 5.9. Within the delivery of large electricity transmission projects TOs regularly outsource large construction and operational elements to contractors. This occurs where TOs consider it the most efficient approach.
- 5.10. The SPV model would expand on this approach to broaden the scope of the procurement to cover all elements necessary for the delivery of a project once it has secured planning consent, ie financing, construction, and operations. The TO would be effectively procuring an end-to-end delivery solution for the project on behalf of consumers. We set out in our August consultation that we expect this approach to drive further efficiency in the financing, delivery and operation of projects. It may also help encourage new entrants into the supply chain.
- 5.11. We envisaged that, under the SPV model, the incumbent TO would run a competition for the construction, financing and operation of the project through a project-specific Special Purpose Vehicle (SPV). The SPV would

deliver the project under the terms of a contractual arrangement (the “delivery agreement”) with the TO. The TO would retain regulatory responsibility (under the terms of its transmission licence) for, and operational control of, the project. The SPV would finance, construct and operate the project for a fixed period (in general we considered 25 years was likely to be appropriate), in return for a defined revenue under its delivery agreement with the TO. Our view was that the capital invested in the project assets would be fully recovered over this period, ie the equivalent of the “regulatory asset value” would be zero at the end of the revenue term.

- 5.12. The TO (or another party proposed by the TO that Ofgem agrees to) would run a competitive tender process to determine the SPV. The competitive tender would be designed with Ofgem input and run with Ofgem oversight. This tender would initially specify and ultimately determine the terms of the contractual arrangements between the SPV and the TO. The SPV competition would determine an annual revenue stream, reflecting the underlying capital and operational costs and weighted average cost of capital (WACC), which would be paid to the SPV by the TO on behalf of consumers. The TO would recover these costs from consumers through its transmission licence.

#### **Next steps on the SPV Model**

- 5.13. In principle we do not consider that the SPV model is inherently more risky or inefficient than the Competition Proxy delivery model. Indeed, the cost benefit analysis in the January 2018 HSB minded-to consultation (published alongside this document) concludes that the SPV model has the potential to unlock additional benefits relative to the Competition Proxy model, particularly in capital and operational cost savings, which would offset the higher costs to consumers of implementing the SPV model.
- 5.14. However, our assessment in the January 2018 HSB minded-to consultation also suggests that if project risks were not allocated appropriately ahead of a competitive process, the SPV model approach could actually increase some costs.
- 5.15. In light of the above, we therefore consider that in order to maximise the benefits of the SPV model, we should take additional steps to set out an efficient allocation of risk across the TO, SPV and consumers before an SPV competition. We should also set out further details on how to ensure a fair, transparent and efficient SPV competition process.
- 5.16. We therefore intend to undertake further development of the SPV model over the coming months, including:
- **The most effective incentives and obligations for the TOs to deliver an efficient tender.** Licence obligations on TOs may not be sufficient to ensure the SPV competition is run to deliver optimum

savings for consumers. Incentives could be used to reward TOs for running the competition effectively. For example, a TO could be allowed to retain a proportion of the overall consumer saving derived from its role in successfully implementing the SPV model;<sup>17</sup>

- **The efficient allocation of risks, in general, across the SPV, the TO, and consumers.** We envisage using our 2015 published work on 'EPC contract principles'<sup>18</sup> for OFTO Build proposals (specifically the 'Generator EPC OFTO build model') as the starting point for this work. We note that a complete risk allocation would still need to be determined individually for each project;
- **The regulatory arrangements underpinning the model, as well as the scope and key parameters of the competitive tender for the SPV.** Different projects are likely to have different characteristics that will be reflected in the allocation of risks. The level of involvement the TO has in the SPV is also likely to be a factor in how risks are allocated. The August consultation explained how the SPV model could be tailored in several ways to accommodate this. However, the benefits of this flexibility must be considered against the benefit of Ofgem further stipulating the core requirements of the model, which would accelerate the process by which the SPV model can be implemented and ensure that consumers are protected from inefficient costs. We anticipate that the core requirements will build on the details we set out within Appendix 1 of the August consultation; and
- **How our processes for decision-making can ensure timely delivery of the project through the SPV model.** We have set out in Chapter 4 our view of the end-to-end process for each of the delivery models, and will further develop the detail of the SPV tender process and timings.

5.17. Though early 2018, we therefore expect to publish:

- Further proposals on TO incentives and obligations;
- Guidance on SPV/TO contract principles and risk allocation;
- Further details on the regulatory model;
- Detail on the SPV tender process and evaluation requirements; and
- Proposed changes to the TO licences to support future implementation of the SPV model.

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<sup>17</sup> This would need to be determined against a counterfactual estimate of costs.

<sup>18</sup>

[https://www.ofgem.gov.uk/sites/default/files/docs/2015/11/epc\\_principles\\_guidance\\_open\\_letter-for\\_publication.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/11/epc_principles_guidance_open_letter-for_publication.pdf)

- 5.18. We intend to engage with industry to develop these arrangements, and we will publish updates on our website to inform interested stakeholders.

### **How we intend to consider SWW projects that are subject to a Needs Case assessment during RIIO-T1**

- 5.19. As set out earlier in this chapter, we consider that the Competition Proxy model could deliver benefits to consumers when applied to projects that meet the criteria for competition. Subject to taking forward the further developments set out above, we also consider that the SPV model could deliver comparable, if not greater, consumer benefits for such projects.
- 5.20. **As such we intend to consider the Competition Proxy and SPV delivery models for all future SWW projects that are subject to a Needs Case assessment during RIIO-T1 and that meet the criteria for competition.** In practice we will therefore carry out at the Needs Case stage, for each SWW project that meets the criteria for competition, an assessment of the consumer benefit of delivery via either the Competition Proxy, SPV or RIIO (SWW) delivery models.

### **Competition in RIIO-2**

- 5.21. We are considering the role of competition as part of our ongoing development of the RIIO-2 price control framework. We continue to consider that we should extend the role of competition, where appropriate and where it can drive value for consumers.
- 5.22. The arrangements for the SPV model and Competition Proxy model described in this document are based on a 'late' competition model (i.e. where competition, or the benefit of competition, is introduced near to or after planning consents have been granted). We consider this focus is appropriate at this time given the progress of SWW projects we have considered to date and expect to consider for competition during RIIO-T1.
- 5.23. As part of our development of the RIIO-2 framework, we will consider the scope of competition further – including the extent of where we might apply competition, as well as considering the stage of project development at which the competition might be run.

# Appendices

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## Appendix 1 – Summary of responses to Questions 1 and 2 of the August 2017 consultation on Hinkley-Seabank

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1.1. In our August 2017 consultation on the Hinkley-Seabank project, we asked stakeholders for their views on our analysis of the suitability of the criteria for competition to the SPV and Competition Proxy delivery models. We received 31 responses to the consultation, of which 17 responded on the criteria specific questions.

*Question 1: Do you agree with our initial views on the appropriateness of the new, separable and high value criteria for the SPV and Competition Proxy models?*

1.2. Most respondents agreed with our initial findings that the criteria are appropriate for the SPV model. Respondents had mixed views on the criteria for the Competition Proxy model. Some respondents noted that one or more of the new, separable, and high value criteria may not be needed for the Competition Proxy model. One respondent noted that we should continue to consider deliverability and transferability during our assessments. One respondent noted that for the purposes of separating operating costs, it may still be beneficial to have clearly defined asset boundaries (ie using new and separable) for the Competition Proxy model.

*Question 2: Do you think the criteria for identifying projects suitable for delivery through models intended to secure the benefits of competition should be the same, irrespective of which delivery model is used?*

1.3. The majority of respondents considered that the criteria could be different between models, reflecting the answers to question 1. Various reasons were given for this, including the lack of different delivery party, and the lower administrative cost of the Competition Proxy model.

1.4. Several respondents considered that the criteria should be the same across all models. Some of the key reasons given were:

- Maintains the continuity of previous policy decisions that only projects that meet all criteria would be subject to competition.
- Minimises the regulatory uncertainty around what is likely to come forward for competition.
- Ensures that the projects that are delivered through Competition Proxy are similar to CATO-style projects.

## Appendix 2 – Criteria analysis tables

Table A2.1 sets out our analysis against the objectives of the criteria for the SPV model.

Table A2.2 sets out our analysis against the objectives of the criteria for the Competition Proxy model.

Table A2.1 – SPV Model

	Objective (May 2015)	Analysis
New	<ol style="list-style-type: none"> <li>1. "...more easily maintain regulatory continuity and clarity for existing asset owners, which is important for achieving long term stability and therefore value for consumers."</li> <li>2. "...new entrants avoid risks inherent in taking over assets that have been operational for some time."</li> </ol>	<ol style="list-style-type: none"> <li>1. Regulatory continuity and clarity for existing owners still relevant and important.</li> <li>2. SPV bidders would similarly need to consider risks in taking over existing TO assets.</li> </ol>
Separable	<ol style="list-style-type: none"> <li>1. "Separable assets can be scoped for tendering more easily and efficiently."</li> <li>2. "...minimises interface complexities between existing asset owners...and new entrants, both during construction and operation."</li> </ol>	<ol style="list-style-type: none"> <li>1. Beneficial for the TO's tender to be able to define relevant assets clearly.</li> <li>2. Similar need for clear boundaries between SPV and other TO assets. However, incentives could be better aligned than for CATO if/where TO retains compliance responsibility.</li> </ol>
High Value	<ol style="list-style-type: none"> <li>1. "benefits from cost savings and innovation will significantly outweigh the potential administrative and interface costs"</li> <li>2. "tenders for projects valued at or above £100m are likely to attract significant market interest"</li> </ol>	<ol style="list-style-type: none"> <li>1. SPV tender likely to have similar fixed costs and benefits (if run efficiently).</li> <li>2. Likely similar SPV bidder market interest considerations.</li> </ol>

Table A2.2 – Competition Proxy Model

	Objective (May 2015)	Analysis
New	<ol style="list-style-type: none"> <li>1. "...more easily maintain <u>regulatory continuity and clarity for existing asset owners</u>, which is important for achieving long term stability and therefore value for consumers."</li> <li>2. "...new entrants <u>avoid risks inherent in taking over assets</u> that have been operational for some time."</li> </ol>	<ol style="list-style-type: none"> <li>1. Regulatory clarity for existing owners still relevant and important.</li> <li>2. No new entrants or existing asset transfer risk. However, benchmarks for determining revenue via Competition Proxy may be more appropriate to new assets.</li> </ol>
Separable	<ol style="list-style-type: none"> <li>1. "Separable assets can be scoped for tendering more easily and efficiently."</li> <li>2. "...minimises interface complexities between existing asset owners...and new entrants, both during construction and operation."</li> </ol>	<ol style="list-style-type: none"> <li>1. No tender necessary, so ease of scoping assets not relevant. But if separable, easier to delineate assets from wider price control arrangements.</li> <li>2. All assets delivered by incumbent, so no interfacing considerations need to be taken into account.</li> </ol>
High Value	<ol style="list-style-type: none"> <li>1. "benefits from cost savings and innovation will significantly outweigh the potential administrative and interface costs"</li> <li>2. "tenders for projects valued at or above £100m are likely to attract significant market interest"</li> </ol>	<ol style="list-style-type: none"> <li>1. No tender or interface costs as delivered by incumbent. However, benchmarks for determining revenue via Competition Proxy may be more appropriate to high value assets.</li> <li>2. No bidding market interest considerations.</li> </ol>

# Appendix 3 – End-to-end processes diagrams

Figure A3.1 Approach for projects with an INC

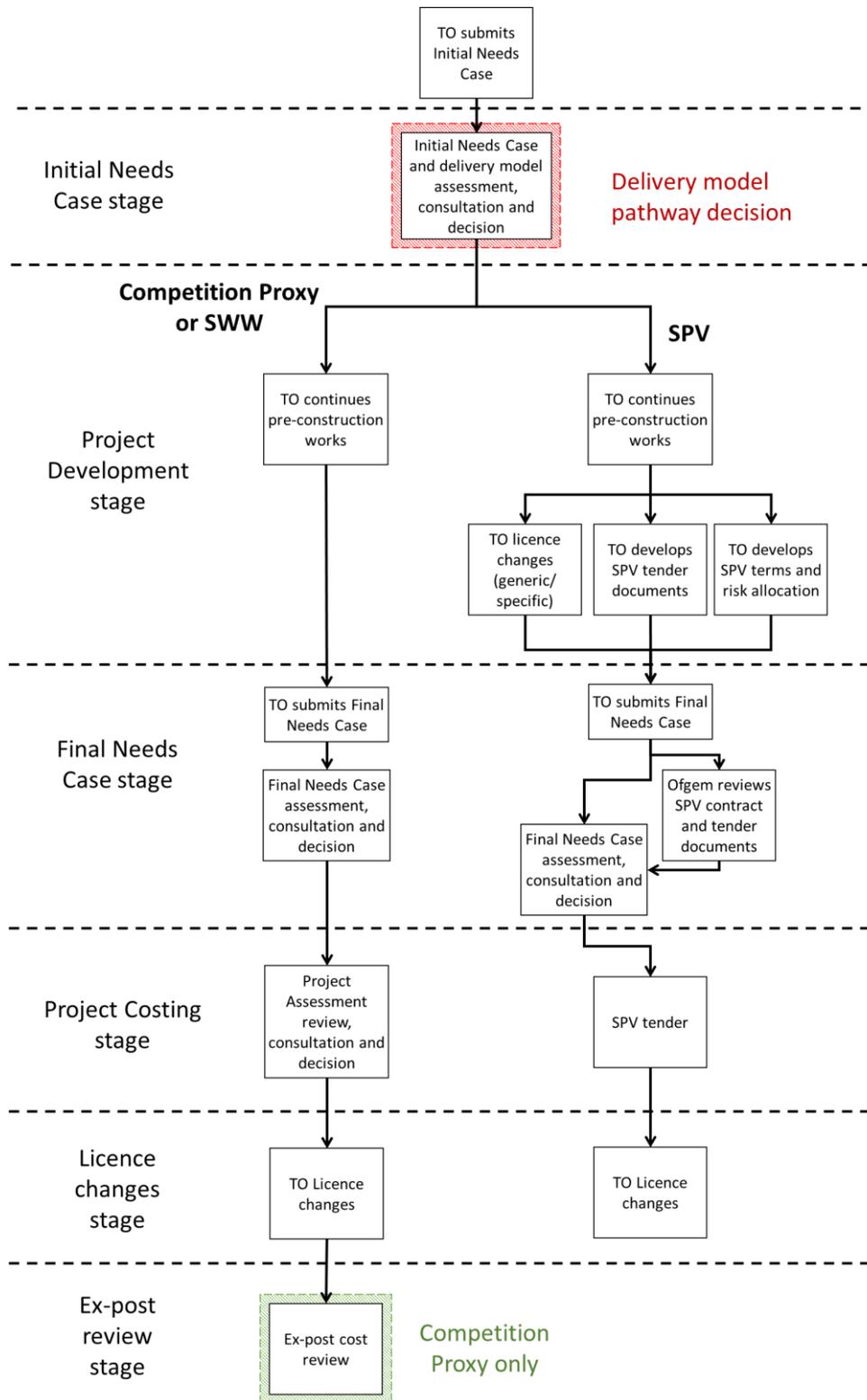
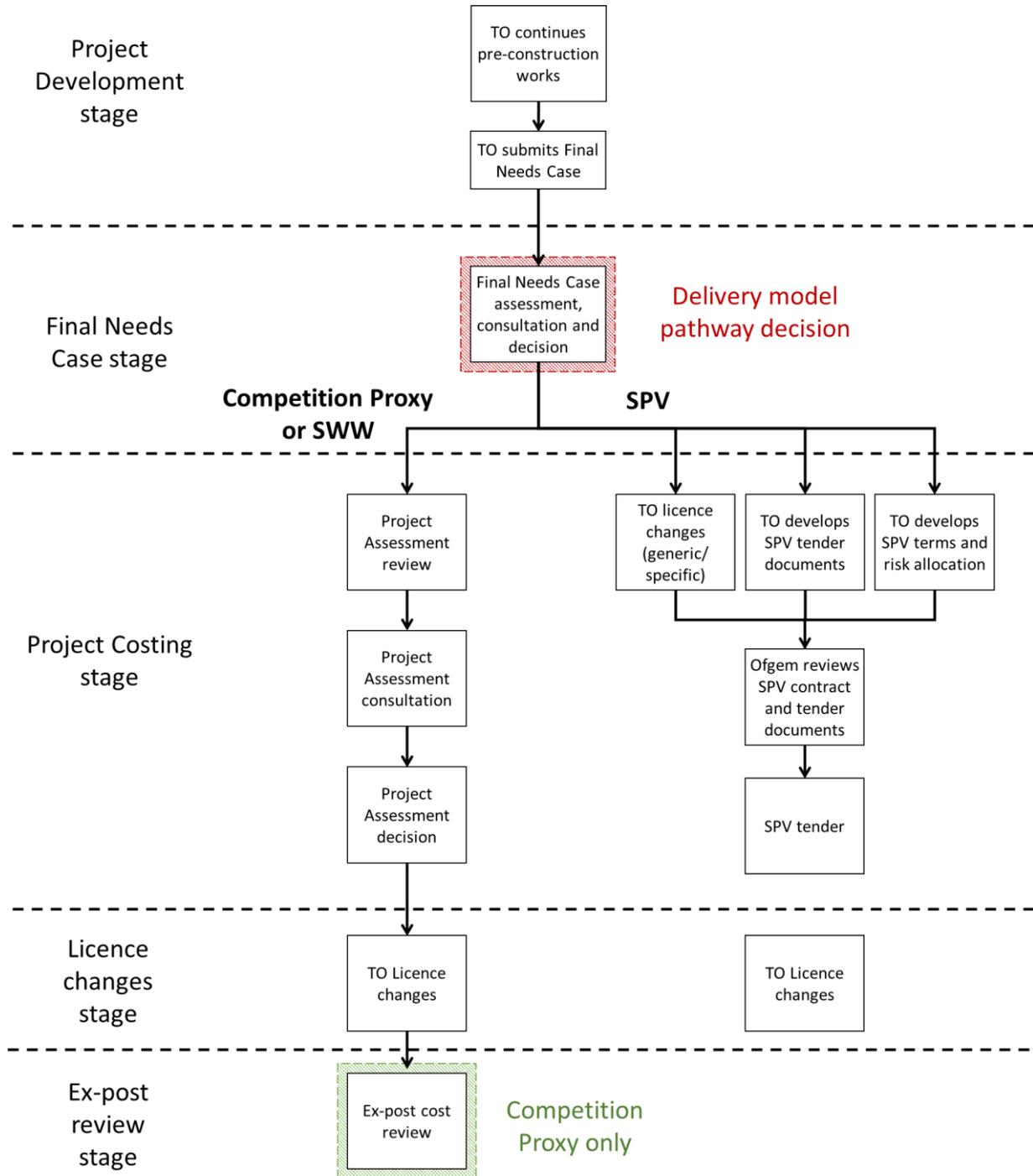


Figure A3.2 Approach for projects without an INC



## Appendix 4 – Principles for packaging

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### **Bundling, splitting, and re-packaging**

We set out in November 2016 that when assessing a project for its suitability for competition, we would consider whether a project should be subject to our principles of 'bundling', 'splitting', and 're-packaging' in line with the competition criteria. We consider that these principles are still relevant when we are considering the suitability of a project for delivery through the Competition Proxy and SPV models. We have restated below our principles for packaging.

- **Bundling – combining smaller projects:** We will combine one or more projects with a common driver into a single project where this makes technical or commercial sense and is in the interests of consumers. This would only apply to projects which already meet the high value criterion in the first place.
- **Splitting – separating larger projects:** We will consider if some projects should be split into separate projects, treated separately, to achieve better outcomes for consumers. We will consider this if a project is particularly high value which could limit the pool of potential bidders, if there is a clear technology split requiring different skills and procurement approaches, or if a multi-phase construction is planned over a long period in discrete and separate locations. Any resulting projects will need to meet the criteria for competition.
- **Re-packaging – re-specifying scope of projects:** We will consider whether a project could be re-packaged into a new project where certain elements of the project do not meet the criteria, for example if:
  - the vast majority of a project proposed is brand new or a complete replacement, but a small proportion involved updating/renovating existing assets;
  - a project as proposed would not be considered separable, but could be re-packaged through minor re-scoping to make ownership boundaries easier to define; or
  - the timing of elements of a project vary such that it may be sensible to separate earlier and later components.

## Appendix 5 - Feedback on this consultation

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We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can.

Unless you mark your response confidential, we'll publish it on our website, [www.ofgem.gov.uk](http://www.ofgem.gov.uk), and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

### **General feedback**

We believe that consultation is at the heart of good policy development. We are keen to hear your comments about how we've conducted this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send your comments to [stakeholders@ofgem.gov.uk](mailto:stakeholders@ofgem.gov.uk)