20 March 2018

James Norman
New Transmission Investment
Ofgem
9 Millbank
London SW1P 3GE

Dear James,

ENERGY NETWORKS ASSOCIATION RESPONSE TO HINKLEY-SEABANK: MINDED-TO CONSULTATION ON DELIVERY MODEL

Energy Networks Association (ENA) represents the "wires and pipes" transmission and distribution network operators for gas and electricity in the UK and Ireland. As private companies providing a public service, our members are responsible for the critical national infrastructure that delivers these vital services into customers' homes and businesses. This response is on behalf of our electricity transmission and distribution members[1].

Introduction

ENA members welcome the opportunity to respond to this consultation on Ofgem's 'minded-to' position for National Grid Electricity Transmission to be funded to deliver the Hinkley-Seabank (HSB) project under a proposed Competition Proxy mechanism.

The consultation proposes that the Competition Proxy mechanism seeks to reflect the outcome of an efficient competitive process for the financing, construction and operation of the HSB project. As part of this, Ofgem propose to apply a specifically determined cost of capital, derived using an updated methodology, to HSB over the period of its construction and 25 years of operation. National Grid Electricity Transmission would receive a project-specific revenue allowance to deliver HSB.

Within our response we have sought to set out the collective views of our electricity network members. Our response therefore sets out a number of key common principles and points on which there is agreement between our members and highlights a number of areas of concern with the proposed approach.

[1] These are Electricity North West Limited, Northern Powergrid, Scottish Power Energy Networks, UK Power Networks, Scottish & Southern Electricity Networks, Western Power Distribution and National Grid.

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Principal concerns

As a principle, our members are supportive of considering new approaches that will deliver clear benefits to consumers. However, any approach should not be considered in isolation from the electricity transmission price control mechanism, the other sector specific price controls and wider markets. Against this, we believe there are three fundamental weaknesses in the proposals as set out under the consultation that we believe will significantly reduce or remove the estimated financial benefit to consumers of pursuing the proposed approach. These are:

- Early stage of development of the proposed Competitive Proxy model;
- Potential reopening of the RIIO T-1 electricity transmission price control; and
- Issues with the applicability of the proposed financing parameters.

Early stage of development of the proposed Competitive Proxy model

Our members have a general concern that compared to the status quo Strategic Wider Works (SWW) framework or CATO model, the proposed model is relatively immature and the implications of its use have not been sufficiently considered.

Our members are concerned that the introduction of an undeveloped and untested alternative model at this stage of the HSB project would introduce a variety of risks that may result in delay and/or increased costs to the project and consumers and deliver a comparatively sub-optimal outcome.

Reopening the Price Control

The RIIO-T1 Final Proposals highlight that Ofgem may consider the role of third parties in delivery during the RIIO-T1 period. In particular, they state that Ofgem may use "*a competitive process to award a TO the revenue stream needed to build, own and operate onshore electricity transmission assets*", under which "*projects treated as SWW in our Final Proposals could be subject to this competitive process and therefore potentially delivered by a third party TO*".

The Competition Proxy does not fit either of these alternatives set out in the Final Proposals. Seeking to deliver the project under the existing licensee's licence but with different financial arrangements could therefore be deemed to be a reopening of the RIIO -T1 arrangements.

Our members are concerned that the proposed approach has the effect of reopening a current price control settlement which would have longer-term and wider ramifications for the market and across sectors, negatively impact on investor certainty and potentially result in significantly detrimental impacts for consumers.

The ENA's response[2] to Ofgem's recent consultation on the potential for an ED-1 Mid-Period Review sets out in some detail the risks and impacts associated with this type of reopener and are consistent with Ofgem's own conclusions contained within MPR Impact Assessments.

Financing Arrangements

The proposed approach to benchmarking costs using information from OFTO and interconnector regimes seems to be inherently flawed, especially for the key financial parameters on which the estimate of potential consumer benefits depend. Offshore connections have very different financial and regulatory characteristics compared to typical onshore investments. For example, in the case of offshore connections the assets are built and commissioned by the developer before a tender takes place, so an OFTO bears no construction risk at all. This means that an OFTO bidder does not need to make any allowance in its required cost of capital for construction risk or delay, meaning this cost of capital is not a suitable benchmark for HSB.

Moreover, the proposed approach uses ring-fenced financial parameters for the HSB project, attempting to treat it as if subject to project finance. However, the project would still be delivered by NGET within its existing ring-fence. In reality, licensees are unable to ring-fence given assets in this way and must raise finance across their portfolio of assets. It therefore may not appropriate to use a project financing proxy to determine the financial parameters for HSB.

Overall, the above points mean that our members are concerned that the proposed financial structure does not accurately reflect the combined costs of equity and debt in the current market (and so would not provide investors a fair return). This raises fundamental questions over the financeability of HSB within the ranges set out in the consultation (derived by CEPA) and we question the assertion that the HSB project could attain investment grade as a standalone entity, even if it were possible to finance on this basis.

Our members are also concerned that any perceived reopening of the price control, mentioned in the previous section, will have an interactive impact, by reducing the attractiveness of investment in GB utilities generally, adding further upward pressure on hurdle rates. Therefore it is difficult to see how rates such as those proposed can be sustained going forward, and any perceived benefit will quickly be lost and have a negative impact.

The evaluation of the potential costs and benefits from applying the competition proxy model to HSB should factor in all of the above points. Moreover, the price control parameters under which the majority of the HSB project would be delivered are yet to be set so it is difficult see how any assessment of the competition proxy

[2] Energy Networks Association response to ED-1 Mid-Period Review Consultation

approach could be done with an appropriate counterfactual ahead of the conclusion of at least the framework stage of the RIIO-2 process. RIIO-1 is not a suitable counterfactual and its use inflates and overstates the claimed benefits.

Conclusion

Whilst ENA members welcome proposals that are in the interests of consumers, there are a number of principal concerns with the proposed approach for the HSB project that have not been adequately addressed given the potential additional risks to the successful delivery of the HSB transmission line and Hinkley Point C project. Our members are concerned that if Ofgem proceeds on the proposed basis then there could be longer term ramifications for investment in GB's energy networks.
If you have any questions on the points raised in this response, please contact John Spurgeon, Head of Regulatory Policy email: john.spurgeon@energynetworks.org

Yours sincerely

David Smith
Chief Executive