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Dear James,

Hinkley-Seabank project: minded-to consultation on delivery model

This response is provided on behalf of National Grid Electricity Transmission (NGET) in its role as Transmission Owner in England and Wales.

Executive Summary

NGET welcomes Ofgem's decision to approve the Final Needs Case for the Hinkley-Seabank (HSB) connection project. NGET does not, however, support Ofgem's minded-to position to apply the Competition Proxy Model (CPM) for the delivery of HSB because the proposal put forward is fundamentally flawed and there is no credible basis for concluding that it is in consumers' interest:

1. The proposed terms have failed to present a robust or coherent 'proxy' for how an alternative developer and operator could deliver HSB. NGET has reviewed the analysis carried out and commissioned work from Oxera (appendix A) and KPMG (appendix B) to do the same. The reports highlight material errors and inconsistencies. Many of the benchmarks used are inappropriate, while more relevant benchmarks and considerations are missing.
2. In part, this failure to produce a robust or coherent 'proxy' is due to the proposed delivery model being underdeveloped and ill-defined, with fundamental elements missing. This is indicative of the speed with which the model has been developed. It is impossible to come to a view on what a competitor would offer without further clarity on how the project is to be delivered.
3. In addition to the above, Ofgem has failed to assess how NGET could deliver the project under its license, and whether the CPM terms would need to be adjusted to reflect this. For example, the broader regulatory structure would not support NGET adopting the financing approach that Ofgem implies would be used by a hypothetical competitor. The proposal as it stands assumes that HSB would be deliverable and financeable when features of a competitive regime are imposed on NGET. Without taking the step to review this assumption, the concept of the CPM is flawed.
4. The combination of material errors and inconsistencies in developing a set of 'proxy' terms, an underdeveloped model, the lack of assessment of how NGET could finance this project, and the lack of a robust counterfactual, mean the overall Cost Benefit Analysis (CBA) cannot be relied upon. Ofgem has under-estimated the costs of delivering HSB under the proposed CPM, and as such has come to an unfounded view of consumer benefit.

5. Finally, Ofgem has failed to factor into its CBA the adverse impact to consumers of re-opening the price control as proposed. This creates regulatory uncertainty, damages investor confidence, and increases the cost of capital for future investments. At the start of RIIO-T1, Ofgem very clearly set out two alternative models for delivering projects such as Hinkley: either via SWW at the RIIO Cost of Capital, or via a competitive process in which NGET could choose whether to bid. No indication was given that NGET would be compelled to deliver based on new terms. The underdeveloped nature of this model only serves to heighten the uncertainty.

Each of these points is further explained in the next section of the response before we then answer the specific questions raised in the consultation.

Overall, Ofgem has failed to put forward a robust and rational case for its CPM proposal. The proposal does not replicate the outcome of a competitive process, the model contains conceptual flaws, and Ofgem has not justified why SWW cannot be used to deliver HSB. Given the need to press on with delivering the HSB project, continuing under the existing SWW model is in the best interests of consumers. NGET will consider all legal options to challenge any decision Ofgem takes to proceed with its minded-to decision to apply the CPM.

Narrative

1. **The proposed terms have failed to present a robust or coherent 'proxy' for how an alternative developer and operator could deliver HSB. NGET has reviewed the analysis carried out and commissioned work from Oxera (appendix A) and KPMG (appendix B) to do the same. The reports highlight material errors and inconsistencies. Many of the benchmarks used are inappropriate, while more relevant benchmarks and considerations are missing.**

   Ofgem attempts to develop a viable 'proxy' to mirror the level at which HSB could be financed and delivered as a standalone project, under a competitive framework. The aim is to "reflect the outcome of an efficient competitive process". However it fails to achieve this.

   The principles of the CPM and use of benchmarks from OFTOs implicitly suggest a project finance approach would be more efficient for HSB. However this appears to be based on a limited understanding of how project finance investments are structured, for example in terms of revenue sculpting, ensuring financeability based on metrics, and risk allocation.

   Our review of the methodology used to build up the terms, supported by work carried out by independent consultants Oxera and KPMG, has identified a large number of material errors and inconsistencies in the way the analysis and benchmarking was carried out. Further detail can be found in the reports attached, but some examples include:

- **Critical trade-offs are missing from the analysis** (e.g. between financial return, risk allocation and capital costs). The analysis does not reflect the way the project would actually be treated under a project finance competitive model, in terms of revenue profiles, checks on financial metrics, risk allocation, and derivation of required returns. In a true project finance approach, the project would need to be viewed holistically in conjunction with investors' assessment of the project risks. We note that given the ill-defined model, it is unclear whether project finance would be the optimal financing approach, but it appears to be the model assumed in Ofgem's analysis.

  A range of project risks are currently borne by NGET, which would be priced into either the capital costs, or the WACC for any 'proxy' competitor. Examples include the alignment between NGET and customer programmes, contractor insolvency, post-Brexit market conditions and shortages of specialist resources and labour. The construction phase incorporates significant risk, such as ground conditions (including contamination and archaeology), risks associated with building the haul road, vandalism and theft, weather, and complex and unforeseen crossings when excavations take place. The operational phase has risks against maintaining availability of the connection. There is little evidence that Ofgem has taken these into account.

  Under a project finance approach, these risks would be specifically defined and placed with either the capital works contractor, or with consumers, in order to achieve a lower cost of capital.

  We have concerns about how the supply chain would respond. Many of the contractors may not be well placed to manage risks which conventionally sit with NGET. At a minimum we would expect the capital costs of the project to increase to reflect the increased risk borne by our contactor base, eroding Ofgem's assumed benefit to the consumer. By enforcing lower headline returns, Ofgem is simply shifting inherent risks onto our contractors and therefore increasing the capital cost of the project.

  This failure of CEPA to make an assessment of HSB-specific risks also undermines the benchmark comparisons made (see below).

- **Benchmarks are inappropriate or inconsistent across the project lifecycle.** There is a lack of readily applicable benchmarks to use for HSB, given that projects such as OFTOs have key differences in scope and technology as well as in regulatory risks. This makes it difficult to establish what an efficient outcome would look like under a competitive approach.

  As such, Ofgem appears to be cherry picking data from regimes and projects with different characteristics, without sufficiently accounting for the specific characteristics and risks of these regimes, or considering whether the benchmarks used are consistent with each other.

  In relation to picking certain points during the project lifecycle, CEPA and Ofgem look at the Interest During Construction in relation to Interconnectors and OFTOs. However investment in interconnectors is not driven by Interest During Construction, but by operational revenues, and there is no precedent for an OFTO build. The incentives to build an OFTO have been driven by the need to connect the windfarm and so secure the revenues from generation.

  In addition, OFTOs benefit from one and a half notches' uplift in their rating as a result of using project finance, and an additional one notch for having the benefit of a European Investment Bank guarantee. The latter is no longer available in the current Brexit environment, and the availability of any alternative guarantee from the UK government is untested. This makes OFTOs flawed benchmarks for the cost of debt. Finally, in the case of OFTOs, winners of the competitions have often made strong assumptions in relation to tax and terminal asset value, which are reflected in the bid WACCs for those assets

  We refer you to Question 2 for our full list of concerns.

- **The cost of capital assumptions and analyses are flawed,** including a fundamental mistake in assuming that asset risk for the project is lower than debt risk, and ignoring costs of key debt securities in the construction period.

  CEPA's estimate for the total market return (TMR) appears unrealistic and does not reflect a balanced view of the available evidence. It also does not account for the negative relationship between the equity risk premium and the risk-free rate, which is recognised in CEPA's subsequent document supporting the RIIO-2 framework.

  The cost of capital is determined across individual phases of the project and there is no assessment as to whether they form a consistent cost of capital across the whole project. Despite CEPA stating that the overall WACC across the project is important to any outcome, it does not provide a view of what the overall WACC would be, and does not undertake the necessary checks to make sure this is deliverable.

  We refer you to Question 2 for the full list of concerns.

- **The implied project cashflows would result in sub-investment grade credit metrics, making the proposed cost of capital unachievable.**

  Independent analysis carried out by Moody's[1] suggests that when the project is considered as a standalone entity, the implied cashflows would result in sub investment grade credit metrics. We have had to make a set of reasonable assumptions given the lack of clarity in Ofgem's proposed model, however our analysis suggests that the cost of debt rates would therefore be unachievable in combination with the other parameters proposed, with the construction risk for debt holders materially under-priced.

[1] *Britain's electricity regulator proposes framework that sharply lowers returns for new transmission projects*, Moody's investors service, 29 January 2018 (available to Moody's subscribers)

A credit rating assessment would take into account both the construction and operational phases of the project and as such the cost of capital for both phases must be considered holistically, reflecting the financeability of the project throughout its lifetime.

Despite the aim of a 'proxy' model being to understand what returns a competitor would be able to offer for the project on a standalone basis, Ofgem's analysis assumes financing rates which would not be a viable investment proposition without the support of NGET's balance sheet. A cross-subsidy of this sort would be prohibited in a true competitive process if the delivery party were an affiliate of NGET.

Even at the top of Ofgem's cost of capital range, the project would not be financeable under the proposed terms, making the cost of capital proposed unachievable, however Ofgem's analysis fails to take this into account.

In summary, Ofgem has failed to develop robust or convincing 'proxy' terms. Further, under the current ill-defined model, investors would not have sufficient visibility of the terms, and therefore would not be willing to sign up to a cost of capital, especially at the ranges proposed.

It is unclear that a fully robust proxy could be developed without a competition having been run for a directly comparable project, however the benefits assumed by Ofgem for the CPM clearly start to fall away once the true costs of such an approach begin to be taken into account.

2. **In part, this failure to produce a robust or coherent 'proxy' is due to the proposed delivery model being underdeveloped and ill-defined, with fundamental elements missing. This is indicative of the speed with which the model has been developed. It is impossible to come to a view on what a competitor would offer without further clarity on how the project is to be delivered.**

The proposed model is underdeveloped, with multiple fundamental elements undefined.

- **The revenue stream for the project is not clear** meaning that cashflows are undefined and the resulting returns required by any competitor cannot be inferred. For example, there is no clarity on whether the return will be real or nominal in nature, and interconnector and OFTO approaches are seemingly applied for HSB despite fundamental differences in the regimes.

- **The full range of project risks has not been defined, and the allocation of those risks is unclear.** As discussed above, the financing costs and contracting approach for the project cannot be determined without a clear understanding of risk. Ofgem has neither defined nor allocated these.

- Ofgem and CEPA state that the project has to be **investment grade** to achieve the proposed cost of capital **but do not define how this is achieved**. Our own analysis, and that published by Moody's and referred to in greater detail in the previous section, suggests that the project cashflow would give sub-investment grade credit metrics on a standalone basis. It is not clear how Ofgem proposes to mitigate this.

- **The surrounding regulatory framework has not been clearly defined and does not appear in line with the principle of a standalone project.** Ofgem has suggested that the broader RIIO incentive schemes would include HSB, to provide suitable incentives for NGET to maintain availability of the connection. However, this creates a dependency between the project and the prevailing price control, contrary to the principle of a standalone model. In addition, Ofgem comments that it plans to "adjust the application of the RIIO sharing factor", to avoid windfall gains and losses during construction, but gives little further detail.

As discussed above, Ofgem appears to have based its view of what a competitor could offer on a project finance funding approach. (It is worth noting that Ofgem's use of a project finance model as the basis of its proxy competition was another factor not made explicit in the consultation report, but had to be assumed from the description of its approach and the benchmarks used.) However project finance requires particular clarity on the questions of risk and cashflow to come to a robust view of acceptable returns.

Without further definition around how the model would work, the proposal is unworkable and cannot be audited, the development of a viable proxy would be unreliable, and any conclusion of potential benefits would be unfounded.

The underdeveloped nature of the model is perhaps not surprising given that Ofgem has reached its minded-to position after undertaking only a few months' work. By comparison the CATO regime had over three years of development. The OFTO regime was developed over a similar multi-year timescale. Developing a workable standalone proposed delivery model would be complex, and require significantly more time and consideration.

3. **In addition to the above, Ofgem has failed to assess how NGET could deliver the project under its license, and whether the CPM terms would need to be adjusted to reflect this. For example, the broader regulatory structure would not support NGET adopting the financing approach that Ofgem implies would be used by a hypothetical competitor. The proposal as it stands assumes that HSB would be deliverable and financeable when features of a competitive regime are imposed on NGET. Without taking the step to review this assumption, the concept of the CPM is flawed.**

   Putting the flawed analysis to one side, Ofgem has developed a proposed revenue stream for NGET based on what a 'proxy competitor' could offer. Even if this were achievable by a third party in the case of a true competitive tender, under this proposed delivery model it is NGET who is obliged to fund and deliver the project within its licence obligations.

   The current licensing structure prevents a project finance approach. Under project finance assets are posted as collateral. However for HSB there is no mechanism in place to license a new entity if a funder enforces the security. As such the value of any assets posted as collateral is lost. Other regimes, such as OFTO, were designed to allow security to be taken over the assets and the corporate vehicle.

   Although alternative financing approaches such as modifying risk-sharing, underwriting options, or indemnification could be considered, these would result in increased costs which have not been factored into the analysis.

   Finally, there are risks that would be remain with NGET regardless of delivery model, and would need to be priced into NGET's terms, on top of any reasonable return calculated for the 'proxy competitor'. For example, late delivery of the HSB project would constitute a licence breach. There are also implications for NGET's wider financial obligations, with Ofgem implicitly assuming that our wider RIIO asset portfolio would be able to offset the gearing levels that Ofgem has proposed.

4. **The combination of material errors and inconsistencies in developing a set of 'proxy' terms, an underdeveloped model, the lack of assessment of how NGET could finance this project, and the lack of a robust counterfactual, mean the overall Cost Benefit Analysis (CBA) cannot be relied upon. Ofgem has under-estimated the costs of delivering HSB under the proposed CPM, and as such has come to an unfounded view of consumer benefit.**

A review of the long list of errors identified suggests that the proposal produces insufficient returns to attract the required investment, requiring a material increase in costs to make the CPM viable. Further, if Ofgem proceeds with the proposed flawed terms, the project would not be financeable and NGET would therefore need to rely on its wider balance sheet to 'cross-subsidise'. Ofgem would be committing future consumers to rebalance this through future price controls, to ensure NGET remains financeable. These impacts would offset any potential benefits that Ofgem is claiming.

In addition, using a counterfactual of RIIO-T1 WACC is not robust given that the majority of spend would be made during the RIIO-T2 price control period, and the parameters for RIIO-T2 are still subject to consultation. As such Ofgem cannot claim any evidence of benefit to consumers.

5. **Finally, Ofgem has failed to factor into its CBA the adverse impact to consumers of re-opening the price control as proposed. This creates regulatory uncertainty, damages investor confidence, and increases the cost of capital for future investments. At the start of RIIO-T1, Ofgem very clearly set out two alternative models for delivering projects such as Hinkley: either via SWW at the RIIO Cost of Capital, or via a competitive process in which NGET could choose whether to bid. No indication was given that NGET would be compelled to deliver based on new terms. The underdeveloped nature of this model only serves to heighten the uncertainty.**

The Government includes predictability as one of the six Principles for Economic Regulation, to "provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence… it should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets"[2].

Ofgem very clearly set out two alternative models for delivering projects such as Hinkley under T1: either Strategic Wider Works, at RIIO Cost of Capital, or via a competitive process to appoint a third party TO.[3]

The proposed CPM is neither of these two models. No legitimate expectation was given that NGET would be compelled to deliver based on new terms. It is unacceptable for NGET to be forced to deliver HSB via a model which was not part of the RIIO deal, and is underdeveloped with material flaws.

Introducing a new delivery model would constitute a re-opening of the RIIO-T1 price control agreement and would drive increased regulatory uncertainty. We are already seeing the impact of Ofgem's proposals on investor confidence.

The effect of this would be to drive up the cost of capital for future investments, and add cost to the consumer, now and into the future. This represents a clear and material disadvantage to the consumer which is bound to outweigh any benefits – were they to be found - through this single project.

Uncertainty only has to increase NGET's broader RIIO-T2 cost of equity by 0.1% to more than offset Ofgem's claimed benefits for HSB (or a lower 0.02% if you assume the uncertainty impacts across the whole energy sector's cost of capital).

In addition, Ofgem's RIIO handbook commits to transparency around how adaption could take place, "taking decisions based on robust and auditable evidence". The underdeveloped nature

[2] Principles for Economic Regulation, BIS, 2011
[3] https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/3_riiot1_fp_uncertainty_dec12.pdf

of this model only serves to further undermine the regulatory regime, increasing cost to consumers.

Given the limited progress that Ofgem has made in developing the proposal at this late stage it is not in consumers' interest to proceed with attempting to push this 'competition proxy' model forward.

Overall, Ofgem has failed to put forward a robust case for its under-developed CPM proposal and introducing the current level of regulatory uncertainty around funding this critical national infrastructure is not in the interest of UK consumers. Any decision to progress with the proposed delivery model would be inconsistent with Ofgem's principal objective and general duties. Ofgem has also failed to justify why Strategic Wider Works cannot be used in the absence of the CATO model to deliver HSB in the consumer interest.

The SPV model is not deliverable in the timescales available for HSB: this view is consistent with many other stakeholders' responses to the August 2017 consultation (including several developers as well as EDF, local stakeholders and other network companies). As such, we do not believe that an SPV competition could be effectively or efficiently implemented for HSB.

Given this information, and the need to press on with delivering the HSB project, continuing under the existing SWW model is in best interests of consumers.

Yours sincerely,

[By email]

Chris Bennett

Director, UK Regulation, National Grid

Responses to specific questions posed by Ofgem

For the reasons stated in the covering letter, NGET does not support Ofgem's minded-to-position to apply the Competition Proxy Model for the delivery of HSB. In so far as responses to specific questions are included below this is without prejudice to that position.

Question 1: Do you agree with our minded-to position to pursue the Competition Proxy model for HSB?

As outlined in more detail in the previous section of this response, NGET does not agree with the minded to position because it is not in the interests of consumers:

1. The proposed terms have failed to present a robust or coherent 'proxy' for how an alternative developer and operator could deliver HSB and there are material errors and logic flaws, with many of the benchmarks used being inappropriate.

2. The proposed delivery model is underdeveloped and ill-defined, with fundamental elements missing.

3. Ofgem has failed to assess how the terms would need to be adapted to reflect that the CPM is not true competition, but instead obliges NGET to deliver the project under its licence obligations.

4. This means that the overall Cost Benefit Analysis (CBA) cannot be relied upon. Ofgem has under-estimated the costs, and as such has come to an unfounded view of consumer benefit

5. Finally, the proposed introduction of the CPM is a re-opening of the price control, which would have an adverse effect on consumers. It would create regulatory uncertainty, damage investor confidence, and increase the cost of capital for future investments.

Overall, Ofgem has failed to put forward a robust and rational case for its CPM proposal. It is not clear that CPM is able to replicate the outcome of a competitive process, and Ofgem has not justified why SWW cannot be used to deliver HSB. Given the need to press on with delivering the HSB project, continuing under the existing SWW model is in best interests of the consumer.

Question 2: What are your views on the appropriateness of the cost of capital ranges developed by CEPA (presented in Table 3.1), and where within the ranges do you consider the rates for HSB would lie?

There are material errors and logic flaws in the analysis provided by Ofgem and CEPA for the cost of capital, so NGET does not agree with the proposed ranges. The earlier part of this response noted a number of areas of concern with CEPA's calculations. This section sets out more detailed observations on CEPA's ranges. This analysis is supported by detailed reviews from KPMG and Oxera, which are included as appendices to this response.

NGET's observations can be summarised as follows:

i) The CPM model is currently undefined, and so no range can meaningfully be provided at this stage
ii) There is a lack of suitable benchmarks available and, where benchmarks have been used, their use is flawed
iii) The relative risk assessment comparing CPM to OFTOs and Interconnectors is flawed. No quantitative assessment has been performed and the qualitative assessment does not consider CPM as a standalone project, in contravention of the principles of the CPM.
iv) CEPA's approach of considering the construction and operational phases separately does not reflect the practice adopted by investors in standalone infrastructure projects

v) At the ranges proposed, the project would not be financeable on a standalone basis and so cannot represent the outcome that a competitive process would generate
vi) The ranges proposed rely on a project finance structure but such a structure would not be available for the CPM using NGET's current licencing structure
vii) There are a number of other points relating to each of the proposals for debt, equity and gearing, including errors in some cases

Each of these areas is covered in more detail below.

i) UNDEFINED MODEL

Before analysing the detail of CEPA's methodology for setting the cost of capital, NGET notes that the CPM is ill defined, with material elements such as the risk allocation between NGET and consumers lacking any detail. It is not possible to define a market price for a model that is not specified, and so CEPA has been set an impossible task. In the absence of much clearer and detailed definition it is challenging to identify investors that are willing to finance such a structure. Those that would be prepared to finance it would most likely require additional return to compensate them for the additional risk and uncertainty.

KPMG states that "Any attempt to specify required returns under CPM at present would need to address a wide range of potential risk allocation outcomes and, therefore, would be subject to wide confidence intervals and significant risk premia. Without further specification, it is unlikely any potential bidder for the project would in fact consider the project in the first place. The minded-to consultation and the associated cost of capital estimates do not appear to acknowledge this uncertainty, or link the plausible range of potential acceptable risk allocations with the derived estimates of required returns." Under the current proposals, investors would not have sufficient visibility of the terms, and therefore would not be willing to sign up to a cost of capital (particularly within the ranges proposed).

In addition, Ofgem's CBA seems to consider the cost of capital in isolation to impacts on the other elements of the project. In any delivery model there are critical trade-offs between financial return, risk and capital costs which need to be assessed for optimum consumer value. At present, Ofgem assumes that cost of capital can be varied with no link to capital costs, which is incorrect. NGET's initial analysis has identified over £100m of costs or risks summarised elsewhere in this response that would need to be factored into the capital or financing costs for the project, undermining the CBA presented by Ofgem.

ii) FLAWED USE OF BENCHMARKS

CEPA makes use of benchmarks to justify its cost of capital range, but their use is flawed. Finding suitable benchmarks is very challenging. As outlined by KPMG in its report:

"Given that there have been no competitively procured projects with the same technology and regulatory risk as HSB under the proposed CPM (nor other similar-sized transmission projects with construction risk in the GB market), it would be difficult for any party, including the Regulator, to establish a robust view on what the efficient outcome, including on capital and operating expenditure (and associated expenditure savings), financing costs as well as optimal risk allocation would look like under a competitive outcome".

CEPA's approach also ignores the potential upside returns to investors in its chosen benchmarks. Observed bid WACCs for competitively tendered assets need to be viewed holistically in conjunction with the investors' assessment of the opportunities to maximise revenue streams and expected returns as well as the project risks. In the case of OFTOs, winners of the competitions have often made strong assumptions in relation to tax and terminal asset value, which are reflected in the bid WACCs for those assets. In the case of interconnectors they have a range of revenue streams

available to them when operational, such as congestion rents and ancillary services. Interconnector developers may therefore be willing to accept a low cost of capital for the construction phase, as they would factor in these future revenue opportunities to their overall business plan.

In the operational phase, CEPA's analysis focuses on the second and third OFTO tender rounds (TR2 and TR3). However, the Competition Proxy model would be the first of its kind, and therefore the first OFTO tender round (TR1) presents a more suitable starting point. Market movements which have taken place since TR1 can be addressed by way of adjustments to market parameters.

In some situations, for example in the case of the Cost and Output Adjusting Events provision within the OFTO licences, the project proved to be more risky than originally anticipated by the party which bid for it. For example, this can be seen in Moody's change of outlook on Gwynt Y Môr OFTO PLC's credit rating[4].

The Thames Tideway Tunnel and Shetland projects encapsulate both construction and operational periods. Despite these potentially being more analogous to HSB, CEPA does not analyse these outcomes and instead moves straight to a split cost of capital approach. This is despite a comment from CEPA that it is the overall WACC figure that would be important in any competitive process – a figure that CEPA does not calculate or seem to assess for reasonableness.

It is also worth noting that the majority of the benchmarks considered result from competitive processes which took place in a more favourable financial climate, before factors such as Brexit and the risk of nationalisation introduced uncertainty to the GB energy industry. The broader macroeconomic position is also changing, with a reduction of Quantitative Easing and expected increases in inflation.

iii) RELATIVE RISK ASSESSMENT

CEPA has not undertaken any form of quantitative risk assessment to inform it on the specific risks of the Hinkley project and how the CPM framework impacts on these. Instead it has relied on a qualitative only assessment of the relative risk of HSB compared to the OFTO and Interconnector regimes.

This in itself is concerning, but notwithstanding this NGET has fundamental concerns with the approach taken to the assessment of relative risk in the appendices to the CEPA report. Consistent with the objective of providing the revenues that may be expected from a competitive process the HSB project should be funded on a standalone basis. It is clear from the CEPA report that this basic principle has not been followed, calling into question the assumptions and judgements used by CEPA in developing its view of required returns. NGET has concerns with many of the individual qualitative judgements but to highlight just two:

- First, the investment intensity of the CPM is judged to be low risk relative to OFTOs and Interconnectors because "Transmission assets for HSB would make up a small proportion of overall NGET RAB. Construction delays or cost overruns would not have material impact on return of NGET." In contrast, Interconnectors are medium risk because "Transmission assets are almost 100% of total project costs. Project returns are more sensitive to transmission construction costs." An assessment on a standalone basis would have CPM as comparable to Interconnectors, which CEPA believes are higher risk than OFTOs for investment intensity.

- Second, CEPA states that the Regime and policy risk element is low risk because the regime is "Stable, predictable, and close to mature onshore networks". The CPM regime was not expected, has not yet been fully developed, and is therefore far from stable or predictable.

[4] https://www.moodys.com/research/Moodys-changes-outlook-on-Gwynt-y-Mor-OFTO-PLCs-rating--PR_364937

iv) SPLIT COST OF CAPITAL

As outlined in KPMG's report, investors in standalone infrastructure projects typically adopt a whole-contract approach combining a holistic assessment of the return over the whole of their investment, potentially offsetting higher risks in one phase with higher returns in another.

By way of example, the financing strategy adopted by Bazalgette Tunnel Limited is to fund both the construction as well as the operational phase of the Thames Tideway Tunnel with debt raised during the construction phase and therefore taking advantage of existing rates and credit spread environment impacting the entire project lifecycle. As a consequence, CEPA's methodology does not seem to represent the most efficient strategy to raise debt finance as it is considering the construction phase separately to the operational phase.

CEPA's methodology assumes that it is possible to refinance HSB between its construction and operational phases. This would require NGET to anticipate the likely cost of capital which it will be able to achieve at a future date, despite the lengthy duration of the construction period and considerable instability resulting from external factors such as Brexit. The 50bps allowance suggested by CEPA is not sufficient to cover this. The cost of hedging forward interest rates (as per market observable costs) is not considered. There is also no true up of allowances for any credit spread risk which cannot be hedged.

Decomposing the WACC into construction and operation periods then simply combining these figures ignores the value created as projects move from construction to operation, which typically would benefit the construction phase equity investor. Weight would also need to be given to market observations for projects which include construction risk. There are numerous discussions on the fact that splitting of the WACC in itself should not make any difference to the cost of capital across the project, yet CEPA's analysis produces an outcome lower than any other regulatory precedent which includes construction, without clear reasons why. The logical assumption is that this analysis has not been performed and as a result the overall WACC is underestimated.

These observations on splitting the WACC are supported by the analysis within KPMG's report: "Therefore, phase-specific required returns could in principle be estimated for each project phase if overall risk is appropriately allocated to and priced under each phase. However, the proposed approach ensures that neither each of the phase-specific returns is consistent with the risk profile assumed in each phase, nor that when taken together, they are consistent with the overall project return that would result in a competitive outcome. Neither the minded-to consultation nor the report by the Regulator's consultants considers the implied overall project return for HSB and its consistency with likely target returns required by bidders in a competitive tender."

Any regulatory intervention replicating an efficient competitive outcome should ensure that investors are, in expectation, allowed to earn a return equal to the investment's cost of capital over the life of the project. However, neither Ofgem nor CEPA has provided any analysis comparing the project's expected lifetime IRR with the WACC for the lifetime of the project as implied by proposals presented in the current minded-to position.

v) FINANCEABILITY AND CREDIT RATING

CEPA states that the standalone project would have to be rated at an investment grade level to ensure that the cost of capital rates it is quoting are achievable. However, it does not seem to undertake a detailed cashflow assessment, and instead relies on read across to the OFTO regime. The OFTO regime would only potentially be analogous for the operational period, but moreover the

credit rating of OFTO debt benefitted from one and a half notches' uplift in their rating as a result of using project finance, and an additional one notch for having the benefit of a European Investment Bank guarantee. These are not available for HSB.

A credit rating assessment of HSB should take into account both the construction and operational phases of the project. The cost of capital for these two phases must therefore be considered holistically, taking into account the financeability of the project throughout its lifetime. As such, it is notable that CEPA's chosen benchmarks consider the two phases of the project in isolation, and do not refer to an overall cost of capital or demonstrate that the project as a whole would be able to secure financing at the proposed rates. Ofgem's definition of the construction and operational phases appears to be motivated by a desire to maintain comparability with the operational phases of the OFTO projects, rather than evidence of investors' funding preferences and strategies.

If HSB were to be assessed on a standalone basis, many of its credit metrics would be inconsistent with an investment grade company. The financial metrics in particular are significantly lower than NGET equivalent metrics: this is supported by the recent Moody's report[5] as well as KPMG's analysis, with the latter stating that "Regulatory precedent supports the view that a comfortable investment grade (blended A/BBB) rating is unlikely to be achieved under the CPM on standalone basis". From a qualitative perspective, de-risking the project by using a project finance structure would improve the project's credit rating. However, in order to obtain project finance at investment-grade rates, HSB would need to have a clear risk sharing mechanism and at the same time offer security to lenders (i.e. it must be possible for funders to enforce any security, which is inconsistent with the existing regulatory framework). Secondly, risk allocation would need to be commensurate with investment grade, largely removing all risk from the project and increasing the capital costs.

Ofgem has not defined whether the revenue stream would constitute a real or nominal return. This would need to be taken into account in order to assess the credit rating of the project.

It would therefore be challenging for HSB as a standalone project achieve an investment grade credit rating, making the suggested cost of capital ranges unachievable for a third party. The project would only be investment grade if it was subsidised in some way by NGET providing finance based on its portfolio of other projects financed under the RIIO regulatory regime. As a cross subsidy would be prohibited if the SPV were an affiliate, and the Competition Proxy model represents the project costs expected from an SPV, this is a flawed approach. The approach is both inconsistent with the stated objectives of simulating a competitive process and in contravention of the Principles for Economic Regulation referred to in earlier in this response.

If HSB were to be assessed as a standalone project under rating agencies' methodologies, its corporate credit ratings would be reflective of the lower of the construction and operational phases and therefore mainly sub investment grade (or very low investment grade). The main reasons for this are the unclear risk sharing mechanism and limited revenue stream for such a long construction phase, refinancing risk between construction and operation, and high gearing during the construction phase. However, Ofgem assumes that HSB would be able to access a cost of debt comparable to that available to high investment-grade companies.

vi) PROJECT FINANCE

The rates proposed for the competition proxy model rely on a project finance structure, but the analysis is based on a limited understanding of how project finance investments are structured (for example in terms of revenue sculpting, ensuring financeability based on metrics, and risk allocation).

[5] "Britain's electricity regulator proposes framework that sharply lowers returns for new transmission projects", Moody's investors service, 29 January 2018 (available to Moody's subscribers)

There is also an implicit assumption that any non-specified risks will simply be absorbed by NGET, and therefore do not need to be priced in.

Further, it is not clear that a project finance approach is the most efficient model for HSB (given that the risk transfer framework is not clear). Even if a project finance approach were to be considered to be the most efficient, it would be challenging to implement, as it relies upon the existence of assets which can be posted as collateral if repayments on debt are not made, and NGET's licence would not allow it to unilaterally surrender the HSB assets to creditors. It would also require a project where technical, environmental, economic and other risks are largely removed or transferred. At present, the unclear risk sharing mechanism would increase financing costs: Ofgem's proposed cost of debt does not account for this.

KPMG's report considers the features of typical standalone structures where a project finance structure is utilised. In considering the implications of the findings, KPMG writes:

"The assumed financial structure underpins the estimated rate of return for CPM. For the reasons set out above, the financial structure assumed represents a significant departure from the structure expected for a typical project finance approach. There have been no precedents for such a financial structure so it may not be achievable in practice. To the extent that the assumed structure is not achievable in the market, it would not be appropriate to estimate returns for CPM using benchmarks based on a typical project finance deal."

It is worth mentioning that even if HSB could enter into project finance (which is not possible under the current licensing structure for the reasons above) and therefore theoretically achieve a slightly higher rating (still at the BBB level) then associated costs such as Liquidity, Debt Service Reserve, Emergency Reserve, Working Capital Reserve accounts would need to be considered. These are all features of typical project finance structures.

vii) OTHER DEBT POINTS

CEPA's methodology to estimate the construction phase cost of debt is not appropriate. Firstly, the lower bound of the cost of debt estimate is based on A-rated corporate bond indices of relatively short maturities while the project on a standalone basis is of significantly lower credit quality. However, the risks faced by HSB during the construction phase are likely to be higher than those faced by UK water and energy utilities on average, the majority of which are rated below A. There is also additional uncertainty, as the Competition Proxy model is the first of its kind. For the operational phase, the same comments regarding credit quality (and therefore relevant indices) apply. Due to the project's credit quality, utilising BB/BBB indices would be more appropriate, as HSB would not be able to achieve an A grade credit rating alone.

In principle, non-recourse debt should be used to ensure less risk for the project; however this would lead to higher cost. This is not sufficiently accounted for in the proposals.

For Transaction Costs, on page 33 CEPA uses a 25-50bps transaction costs allowance. If, however, the costs in CEPA's preceding paragraphs are added together (15-25bps for financing transactions, and as high as 35bps for cost of carry), the range would be 50-60bps.

CEPA's range for the construction phase cost of debt is largely based on spot and one-year average yields on a selection of investment-grade UK non-financial corporate and infrastructure bond indices. To lock in spot interest rates would require issuing all debt upfront resulting in a negative cost of carry. Transaction costs are not a substitute for cost of negative carry and would need to be considered separately and in more detail.

viii) OTHER EQUITY POINTS

Oxera's report shows that CEPA's analysis is flawed, suggesting a level of asset risk which is lower than the debt risk. For the operational phase, Ofgem's proposed WACC estimate of 0.60–1.75% implies a risk premium on the asset (ranging from 0.69% to 1.32%) which is below the implied risk premium on (lower risk) debt instruments (ranging from 1.08% to 1.33%). This is fundamentally incorrect, as the risk premium on unlevered equity assets must be higher than the risk premium on debt assets of the same company since the latter stand in higher priority in any bankruptcy.

CEPA's estimate of Total Market Return (TMR) is significantly lower than that used by any UK regulator, including Ofwat's PR19 methodology from December 2017, and relies on a negative forward view for economic growth. Both Oxera's and KPMG's analysis shows that CEPA's estimate is not robust, and does not reflect a balanced view of the available evidence. Specifically it appears to overlook the increasingly held academic view that the TMR is relatively stable over time. This same conclusion has previously been relied on by Ofgem and is used in the recent RIIO-2 framework document. By placing no weight on historical average equity market returns, CEPA's approach to estimating the TMR does not engage with this issue at all. Further, Oxera's report challenges the robustness of the CEPA analysis which relies on a limited evidence base to derive estimates significantly below those used by, for example, the Bank of England.

CEPA's approach to WACC assessment is also inherently incorrect. If CAPM is to be used, it would need to be adjusted. CAPM by its nature should be applied when a normal distribution of returns can be assumed without asymmetric risks, and its application to a single project would require additional adjustments to ensure that downside scenarios have been reflected. The issues of premia for downside scenarios and asymmetric distribution of returns are covered in more detail in the KPMG report.

ix) GEARING

There is no precedent for a comparable UK project with such a long construction life with 37.5% gearing during construction achieving an investment grade credit rating. The 37.5% figure is derived from the midpoint of two extreme sets of values, and therefore does not provide a meaningful benchmark.

We also note that the higher figure contributing to this benchmark is derived from the NSL interconnector. However, NSL was not asset financed, but rather used the corporate funded route with financiers taking borrower risk at the group level, giving an incorrect benchmark.

In the past, the European Investment Bank has provided loans for standalone regulated electricity transmission assets, which has facilitated the use of high gearing ratios whilst still achieving an investment grade credit rating. Funding of this nature cannot be relied on going forward due to Brexit.

For the operational phase, CEPA's gearing proposal is inconsistent with its cost of debt estimate, and analysis from ratings agencies suggests that such high levels of debt may not be sustainable for HSB when considered as a standalone project. Oxera's analysis shows that the constituent firms in the iBoxx bond indices used to derive the cost of debt estimate have gearing levels significantly below CEPA's range. If the iBoxx indices were to be adjusted to take into account the proposed higher gearing level, this would result in a higher cost of debt.

KPMG's report also points out that the significant increase in gearing between the construction and operation phases also "implies that a large portion of the initial equity exits immediately after construction (circa two thirds) – a strong assumption which might be unrealistic in this case".

In practice, such a step change in gearing levels would not be expected, as infrastructure projects are funded on the basis of the whole project lifecycle. For example, there is evidence of some de-gearing of OFTOs over time. This is supported by Moody's rating reports which indicate that gearing reduces over the early years of these financings. It is worth mentioning that projects such as TTT operate at a

60% gearing level during their operational phase, and have covenants that will constrain them from operating at gearing levels above 70%.This is consistent with the recent speech given by Ofwat's Jonson Cox, which warns against gearing levels higher than 70%.[6]

Question 3: Are there any potential costs or benefits of the Competition Proxy model that we haven't considered?

Ofgem has not given sufficient weight to the statement in its impact assessment that "the Competition Proxy model could raise costs for consumers in the long run by reducing regulatory confidence". Although Ofgem considers this to be mitigated by the fact that the Competition Proxy model could only be used for projects which meet the criteria for competition, it is still contrary to investors' expectations that NGET's overall allowed cost of capital would be that set out in the RIIO-T1 final proposals. Rating agencies have judged Ofgem's proposals to negatively affect their assessment of NGET. As it is these agencies which provide the credit ratings that give signals to investors, their views hold significant weight with regards to NGET's financeability. At the start of RIIO-T1[7], Ofgem stated: "We do not expect to review past expenditure, financial assumptions (e.g. components of the allowed return) or incentive arrangements for cost efficiency or existing output incentives." Statements of this type provided investors with comfort that particular elements of the price control could not be changed, providing for a sustainable, long-term approach to be taken.

When quantifying the benefits of the Competition Proxy model, Ofgem should be explicit about how it envisages that the use of an alternative risk allocation for HSB will reduce costs for consumers. Transferring risk away from NGET would either mean placing more risk onto contractors, which would result in higher capex costs (and would be difficult to do at this stage without re-running elements of the procurement process), or placing more risk onto consumers (which could result in consumers paying more if high impact low probability events occur, and is contrary to the principle of risks sitting with the party best placed to manage them). The existing SWW approach for risk allocation between NGET and contractors is appropriate, and results in a good deal for consumers. Pushing more risk onto contractors would result in inefficient pricing, as contractors would not be well placed to manage many of the risks which conventionally sit with NGET. The existing SWW model also only exposes consumers to a fixed proportion of any overspend, gives consumers a chance to share the benefits of any underspend, and incentivises NGET to manage risk: this is a proven approach which works well. It would therefore be helpful for Ofgem to articulate how a different allocation of risk would result in a net benefit to consumers.

Introducing a new delivery model at this stage of the HSB project creates significant uncertainty for NGET and its investors. This has not been quantified in Ofgem's cost-benefit analysis.

A standalone HSB project with the revenue stream proposed by Ofgem would not achieve a credit rating comparable to NGET's and its credit quality, as explained above, would most likely be below investment grade. As the cost of capital parameters proposed rely on the assumption that the project can borrow at rates consistent with a high-investment grade company, it is therefore assumed that NGET's balance sheet would have to be used to achieve the proposed cost of capital. This introduces an inherent cross subsidy from NGET to HSB (due to the credit rating differential of at least 3 notches: A3 vs low or sub-investment grade), as HSB's financial metrics are significantly lower than NGET's metrics, and as the project finance route is not available under the current licensing structure. Not only would this result in a cost of capital unrepresentative of what a third party could achieve, but it would reduce NGET's headroom for further investment in RIIO-T2. The effect of this has not been quantified. Any such reliance on NGET's broader portfolio and balance sheet to co-insure or subsidise

[6] https://www.ofwat.gov.uk/wp-content/uploads/2018/03/Jonson-Cox-speech-at-Water-City-UK-1-March-2018.pdf
[7] https://www.ofgem.gov.uk/ofgem-publications/51871/riiohandbookpdf

the HSB project will likely require Ofgem to make offsetting adjustments in other NGET price controls to ensure NGET remains financeable.

Ofgem's assertion that the Competition Proxy model would benefit both current and future consumers by way of reducing the annual revenue figure for HSB is dependent on flawed assumptions. It assumes that the currently proposed cost of capital and capex figures are compatible and therefore workable, although in practice higher capex costs would be expected if risks were to be priced at the P80 level or passed to contractors in order to allow for such a low cost of capital. Ofgem also does not take into account that the reduced regulatory stability associated with this re-opening of the price control would have a knock-on effect to the financing costs for other projects, resulting in an overall dis-benefit to consumers.

Question 4: Do you agree with our proposed approach to setting NGET's revenue allowance for HSB, including permitting NGET a revenue allowance during the construction period?

Oxera observes that regulators have consistently set allowed returns for utilities above the UK government's social time preference rate (3.5%)—the rate at which the government discounts publicly funded projects. KPMG further observes that "it may not be optimal to frontload revenues if the social discount rate (as at the Treasury Green Book) is high and potentially higher than the cost of capital for regulated infrastructure investments". Under these circumstances it is not in the interests of consumers to front-load revenues over a 25 year rather period rather than the 45 year period under the SWW regime.

Front-loading revenues does, in principle, assist with financeability but Ofgem's currently proposed ranges would result in a sub-investment grade project. It does not consider the project as a whole, or take into account cash flow considerations.

The low cost of capital proposed for HSB could only be achieved using a project finance approach. If a project finance structure were to be adopted, revenues would be based on the output of a financial model to ensure debt service cover ratios were maintained in line with the various covenants lenders would require.

However, as NGET's licence does not permit it to either ring-fence the HSB assets and finance them separately, or securitise the HSB assets and post them as collateral, a project finance approach is not feasible under the current licensing approach. Although alternative approaches such as modifying risk-sharing, underwriting options, or indemnification could be considered, these would result in increased costs which have not been recognised, and would require detailed bottom-up analysis in order to be accurately quantified.

Ofgem's proposed approach to setting NGET's revenue allowance does not account for the re-financing risk which is present between the construction and operational phases. In order for the project to be a viable investment proposition, this risk would need to be allowed for, either by way of a higher cost of capital, or a specific allowance. There is also an inherent assumption of cross-subsidisation from NGET's balance sheet, as a standalone project of this nature with the proposed revenue stream would not be expected to attract the investment-grade rating which is assumed in the cost of capital parameters.

The revenue stream as proposed would also not achieve investment grade credit metrics, partly due to the inadequate cashflow during the construction phase. Conceivably, receiving additional revenue during construction would help with the financeability of HSB. However for the operational phase, a fixed revenue stream is inconsistent with an assumption that gearing will remain at a fixed percentage during the operation phase.

In summary, NGET does not agree with the proposed approach.

Question 5: What are your views on the two alternative approaches to setting cost of debt and equity during the operational period?

In terms of the timings of setting the cost of capital for the operational phase, Ofgem's proposal is not sufficiently developed to allow for NGET to assess the two options.

Question 6: Do you agree with our proposed regulatory arrangements to implement Competition Proxy?

What do you think of our proposals in relation to setting capex?

NGET is concerned that, in order to meet timescales, it will be necessary to place contracts with no clarity around the regulatory framework and who is bearing which risks. This increases the risk of inefficient decisions being made, increasing costs to consumers. An early decision to retain the SWW model for HSB is the best way to resolve this concern.

NGET does not agree to Ofgem's capex proposals. It is not clear how the capex levels can be reduced without adopting a fundamentally different contracting approach.

It is important to note that capex levels and cost of capital cannot be set independently. A low cost of capital could only be achieved where the majority of the project is de-risked in order to facilitate a project finance approach. De-risking the project would either mean higher capex (which would either be due to getting contractors to bear risk at a level that is not efficient, or by NGET including a greater risk premium such as by submitting P80 rather than P50 costs), or introducing a Post Construction Review which reduces the incentive on NGET and contractors to manage risks efficiently.

The contracting strategy NGET has used to date is based on the legitimate expectation that an SWW approach would be used, whereby costs would be set ex-ante and subject to the sharing factor defined under RIIO. At Ofgem's request, risks in NGET's current estimate (as presented in the Final Needs Case) were quantified and priced at the P50 level. Ofgem has been informed of this strategy, and if it was felt that NGET's contracting strategy was not consistent with the Competition Proxy model then concerns should have been raised at an earlier stage. Given the need to ensure the timely connection of Hinkley Point C, the procurement process currently underway is for approximately £400m of estimated contract value.

Placing all risk with contractors would require a different contracting strategy to be used, and could significantly increase the capital costs of the project due to a transfer of risk to the suppliers. This would also require many contracts to be re-tendered or changed, taking time and increasing cost. Similarly, NGET could price risks at the P80 rather than P50 level, but this would result in increased capital costs.

Ex-ante setting of allowances, with a sharing factor to incentivise NGET to drive further cost reductions and actively manage risk, is a tried and tested approach which drives reduction rather than justification of costs, and places risk with the party best placed to manage it. It is in the interests of consumers, allowing them to share in savings and be insulated from overspend. However, a project finance approach is associated with de-risking a project, and so the cost of capital proposed is not consistent with the current contractual approach (including the level of risk sitting with NGET), or the current contractual approach and indicative cost estimates.

Ofgem's analysis does not account for the full range of risks to which NGET is currently exposed, or allow for these risks to be apportioned to the party which is best placed to manage them. The contingency included in the Final Needs Case estimate does not account for a number of risks borne by NGET, such as the alignment between NGET and customer programmes, contractor insolvency, post-Brexit market conditions and shortages of specialist resources and labour. The SWW approach uses a sharing factor to lessen the extent to which these risks which are borne by consumers.

The construction phase incorporates significant risk, such as ground conditions (including contamination and archaeology), risks associated with building the haul road, vandalism and theft, weather, and complex and unforeseen crossings when excavations take place. The example of building the Milford Haven pipeline showed that significant overruns in both cost and time can take place during construction even after the DCO has been granted, for example due to issues with protestors. Late delivery of the HSB project would constitute a licence breach: this is a risk which would remain with NGET under any regulatory model.

In addition, Ofgem is proposing that WPD's costs sit within the Competition Proxy model. Whilst control measures such as co-ordination meetings, challenge and review of estimates and risks, and performance management can be used, WPD's costs are not within the control of NGET and there is therefore the possibility of underspend or overspend beyond NGET's control. Using a pass-through arrangement for the efficient cost of these works would mean that NGET would not be subject to a windfall gain or loss resulting from activities outside of its control: this would be more consistent with a model where the project is de-risked (as would be the approach under project finance). However, NGET recognises the need to retain incentives for efficient delivery of the project: further discussion is required on the appropriate treatment of these costs.

Ofgem considers that a 5% saving in capex costs is possible under the Competition Proxy model. However, it is not clear how this could be achieved, as any changes to the contractual treatment of risk to facilitate a low cost of capital would be associated with an increase in capital costs. If it is envisaged that more risk will sit with consumers, the consultation should explicitly recognise this, and discuss the costs and benefits of such an approach.

The Project Assessment process due to commence this summer gives the opportunity for Ofgem to determine whether NGET's proposed capital costs are appropriate. To imply within this consultation that Ofgem will look to apply a 5% reduction would seem to pre-empt the outcome of the Project Assessment process. It also sends the signal to prospective contractors that a 5% reduction in their tendered costs will be expected, which could influence market behaviour. A model whereby contractors' and subcontractors' costs are squeezed beyond a level that the market is able to bear could give rise to financial difficulties within subcontractors, which could compromise the timely, safe and efficient delivery of the project. It is also not clear how Ofgem derives its figure of 10% capex savings from a 30% reduction in overheads and contingency and 5% reduction in contract costs. It is also worth noting that the TNEI report[8] commissioned by Ofgem found NGET's proposals for both overall capex and treatment of risk to be appropriate, with the exception of extreme weather and flood risk, which will be excluded from the core estimate to be presented in the Project Assessment submission.

NGET's existing contracting strategy results from analysis of the market as part of its procurement process. The use of frameworks means that bidders are pre-qualified as meeting the relevant technical, safety, quality and financial stability criteria, and also significantly reduces the time and cost of procurement compared to running a full OJEU procurement event. NGET's list of Framework Suppliers covers 77% of the UK utilities construction market, and NGET actively encourages pre-qualified contractors to submit a bid, in order to test the market to the greatest extent possible.

As a result of the timings for HSB, the use of frameworks was the only viable option. This was due to the need to wait for EDF's Final Investment Decision, and the need to complete the procurement process earlier than would otherwise be the case in order to allow for market-tested prices to be submitted to Ofgem in the Project Assessment.

[8] https://www.ofgem.gov.uk/system/files/docs/2017/08/hsb_tnei_report_redacted.pdf

As part of the procurement strategy for HSB, NGET considered three alternative contracting models: a single entity (such as a joint venture or integrator), multiple entities (bundling by asset type) and multiple entities which are scope and scale driven. Each delivery model was assessed from the perspective of capability, capacity, programme and cost. The model of using multiple entities which are scope and scale driven was found to be the best model overall, and was therefore taken forward. Having robustly assessed the options, NGET can be confident that its submitted capital costs are representative of the best value available in the market.

It is unlikely that an SPV model would have driven a reduction in overheads, given that the TNEI report[9] stated that NGET's justification for its capital costs appears reasonable. NGET's overheads are shared among a portfolio of projects, whereas an SPV would require its own standalone resources (such as its own PMO function), as well as incurring some NGET management costs as NGET would need to ensure that its licence obligations are fulfilled. This would result in an extra layer of project management, leading to increased costs. It is therefore not clear how a reduction in overheads could be achieved under the SPV model, or why Ofgem can assume that a similar saving would be available under the Competition Proxy model.

Under the SPV model, risk contingency could be expected to increase if an SPV took on risks that it was not well placed to manage. As a Post Construction Review is not proposed for the SPV model[10], there would be no mechanism to pass on more risks to consumers.

What do you think of our proposals in relation to arrangements during the operational period?

The consultation refers to a 5% reduction in opex costs resulting from the use of the Competition Proxy model. NGET cannot see the rationale for expecting such a reduction, as the HSB assets would be operated and maintained in the same way regardless of whether a Competition Proxy or Strategic Wider Works model were used. Indeed, if HSB were to be priced as a ring fenced standalone project, this would mean that no portfolio effect would be applicable, and therefore opex costs would be higher than under Strategic Wider Works (e.g. for the retention of standalone strategic spares, which would otherwise be held on a portfolio basis). It is also important to note that separate reporting of operational costs would create an additional overhead: this would need to be factored into the agreed opex costs.

Although NGET recognises that including HSB within the incentive arrangements of the prevailing price control would prevent unnecessary complexity, this is incompatible with the concept of the Competition Proxy model representing a standalone revenue stream which for a project which could be delivered by a third party. Using a common incentive package would create additional cash flow uncertainty as the incentive structure could change in each successive price control, further increasing the challenges of raising finance for the project. However, introducing bespoke incentives for HSB would introduce revenue certainty, which is not accounted for in the proposed cost of capital figures.

Question 7: Do you agree with our proposed treatment of low probability, high impact events that NGET cannot control?

NGET agrees with the principle of using a Post Construction Review to fund low probability, high impact events which are outside of its control. NGET should be incentivised to minimise the costs it can control, however windfall gains and losses as a result of events outside of its control are not appropriate.

[9] https://www.ofgem.gov.uk/system/files/docs/2017/08/hsb_tnei_report_redacted.pdf
[10] https://www.ofgem.gov.uk/system/files/docs/2018/01/competition_update.pdf

It is not possible to quantify the level of risk during the construction and operation periods, as Ofgem has not clearly set out which costs are subject to a Post Construction Review (for construction) or reopener (for operation). Ofgem has also not defined the extent of the sharing factor which will be applied to those costs which are set ex-ante.

Some risks, such as ground conditions, are well suited to ex-ante cost setting with a sharing factor. Although ground conditions cannot be directly controlled, they can be managed as part of a set of risks within a portfolio, or incentives can be placed on contractors to deal with such risks effectively. However, any risk being taken within the construction period would require adequate return: this is not recognised in the CPM proposal.

Under the existing Strategic Wider Works model, NGET prices in risk on a P50 basis, meaning that costs are estimated at a level where there is an equal chance of an overspend or underspend. NGET can then manage project risks at a portfolio level, and is incentivised to do so as it will be exposed to a sharing factor for any overspend or underspend. This is consistent with the principle of risk sitting with the party best able to manage it, and is an approach agreed with Ofgem at the start of RIIO-T1.

However, discussions with the supplier base have indicated that a standalone project would not be willing to bear the same level of risk as NGET would under SWW without a significant cost premium, especially if it were to accept a low cost of capital. In order to use a project finance approach, a competitive bidder would either require higher capital costs as compensation for bearing this level of risk, or seek to pass the risk to consumers by way of a Post Construction Review. Passing on the risk to consumers in this way would disguise the full costs of the project to consumers, and would not promote active risk management.

The proposed Competition Proxy model is therefore inconsistent with the previously preferred approach, and inconsistent in itself as it expects that lower WACC and lower capex costs can be achieved for the same project.

Although the detail of such risks will form part of the Project Assessment process, it is important to note that the treatment of risk and magnitude of sharing factors cannot be considered separately from the cost of capital, as this influences how much risk sits with NGET, and therefore how it should be funded for its exposure to risk. The risk allocation structure and methodology for calculating cost of capital would therefore need to be assessed holistically.

Question 8: What are your views on whether a specific allowance set as part of Project Assessment, or a pass-through of incurred taxation constitutes the most appropriate approach for HSB?

As noted above, strong tax assumptions may have sometimes contributed to winning OFTO bidders. NGET does not believe it is in the interests of consumers for there to be a potential for windfall gains and losses on tax. Equally, the providers of finance want relative certainty of revenues. NGET would suggest an upfront specific allowance with clearly defined reopeners as the most appropriate approach, consistent with the current SWW mechanism.