Network Planning & Regulation

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Date:
20th March 2017

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Dear James

Hinkley-Seabank project – minded to consultation on delivery model: SP Transmission's Confidential Response

SP Distribution plc, SP Manweb plc, and SP Transmission plc ("the network companies") are the Transmission and Distribution licence holders within the "SP Energy Networks" (SPEN) Business. This response is from SP Transmission plc (SPT) the onshore Transmission Owner (TO) for the South of Scotland.

As a TO we must ensure that we develop an **economic, efficient and coordinated** onshore transmission system. We therefore welcome the opportunity to comment on this consultation.

SPT has supported the concept of competition in onshore networks in the correct circumstances. SPT has advocated the "early model" as the best way to achieve the outcome from competition that ultimately benefits customers but also we have raised concerns over the potential timing impact that any new tendering process could add to critical national infrastructure projects.

SPT already tenders in the open market c.95% of its activities, and any associated benefits are passed to GB customers, as well as ensuring efficient and effective delivery of our T1 programme.

The recently introduced concept by Ofgem of the Competition Proxy Model (CPM) is neither competition nor efficient regulation. It is a distraction from what Ofgem should be concentrating on in RIIO 2 to ensure the long term interests of GB customers. Ofgem should ensure their priorities are ensuring RIIO 2 balances the interests of investors and customers.

Regarding this consultation SPT has grave concerns regarding what is proposed and believes that Ofgem has failed to:

I. Undertake the appropriate consultation process that a licensee has a legitimate right to expect when Ofgem are seeking to determine its remuneration for a relevant investment;
II. Recognise the extensive process Ofgem has gone through on ITPR and CATO to establish the necessary legislative arrangements for competition to be introduced;
III. Demonstrate the benefits case and proper risk assessment for applying either of the models, nor establish that these are better than the Strategic Wider Works (SWW) mechanism available to it;
IV. Establish a valid fact and market led case for the numbers they have estimated in relation to National Grid's cost of finance for this project;

V. Recognise it is reopening the National Grid TO price control via proposed framework it is "minded to" implement which is contrary to the public commitments Ofgem has unambiguously made about **not** reopening the RIIOT1 price control.

SPT welcomes a properly constructed competitive model that puts all parties on a level playing field. As a small Transmission Owner relative to NGTO we would also welcome being able to compete and grow through new opportunities. However, the introduction of the CPM for SWW projects would be considered by our company and our investors to effectively be a re-opening of the existing price control and therefore calls into question the long understood stability of the GB regulatory regime. Furthermore, it has not been made clear why a 25 year period compared to the 45 year period set under RIIO is appropriate as this may result in an intergenerational impact. Flexibility exists under the main RIIO framework for TO's to secure the optimal cost of capital terms available over a variety of periods when they require to secure debt over their portfolio of projects. Investors already have the flexibility to secure finance over shorter periods than the 45 year depreciation period, which aligns to the operational life of the assets. Fixing over 25 years adds a constraint which may reduce consumer benefit.

The proposed CPM does not extend competition into electricity onshore transmission as envisaged in Ofgem's RIIO-T1 final proposals or subsequent consultations. To put it simply, no direct competition or competitive tendering is introduced at all through the CPM.

Given the serious issues we have listed above, it is our view that the SWW projects should continue to be developed under the established SWW process until a tested and lawful regime that effectively extends competition into onshore transmission has been thoroughly consulted upon and agreed by all stakeholders.

This is not a trivial matter; SPT (like all TOs) performs a critical role in terms of ensuring the resilience and security of our Main Interconnected Transmission System in GB. We also play a key strategic role in maintaining and facilitating the connection of renewable generation, in line with Government's decarbonisation targets. Over the first 4 years of the T1 price control, our shareholders have invested c.£1.5bn in our transmission network, a rate of investment that has been unprecedented since privatisation.

The majority of this investment has been focussed on upgrading and extending the network to accommodate changing needs, such as increased renewable generation and the closure of large thermal power stations. Since 2013, we have connected 872MW of new generation directly to our system. We are also well advanced in delivering an increase in Scotland-England transfer capacity from 2,900MW at the start of RIIO-T1 to 6,600MW, a major component of which is the world leading Western Link HVDC project which we are building in joint venture with National Grid. For this excellent service, the typical domestic customer will pay approximately 10p per day. Therefore, it is our view that the existing RIIO framework has benefitted consumers and should continue to improve service at a fair cost to consumers as we embark on the RIIO-2 negotiation process.

As we make clear above, the existing regime has delivered significant benefits to consumers. The existing SWW mechanism ensures that the financial parameters of the price control are applied to the relevant project, and such financial parameters cannot be re-opened. Price Controls are effectively regulated regimes which already operate as proxies for competition.

Please find enclosed:

Appendix 1: Further detail in relation to each of the points listed above
Appendix 2: NERA's 'Review of Ofgem's proposed WACC for Competition Proxy Model of delivering new onshore capacity investments'
Appendix 3: Letter to Dermot Nolan emphasising four particular points of concern about the proposed Competition Proxy Model

Yours sincerely,

Scott Mathieson
Director
Network Planning and Regulation

Appendix 1:

I. Undertake the appropriate consultation process that a licensee has a legitimate right to expect when Ofgem are seeking to determine its remuneration for a relevant investment

In advance of making any decisions, Ofgem is required to consider the interests of consumers from carrying out its functions and whether there is any other means to protect those interests. At all times, Ofgem must also ensure that its regulatory activities are accountable, transparent, proportionate, consistent. Furthermore, this should apply only to cases in which a solution is required to fix a problem.

SPT does not believe that the CPM or SPV have been subject to sufficient cost benefit analysis, risk analysis or consultation, which are required prior to implementation. The development of the CATO model took place over several years. In contrast, the CPM and SPV models have been developed by Ofgem over a very short period. We are concerned that the SPV and CPM's as proposed may apply to future onshore transmission investments, therefore both models must be consulted on across all price controls and not solely in relation to one project. This is especially important as each project has its own intricacies such as different geographies or technologies utilised.

II. Recognise the extensive process Ofgem has gone through on ITPR and CATO to establish the necessary legislative arrangements for competition to be introduced

Whilst the decision to delay the implementation of the required legislation for the CATO regime was taken by Government and not by Ofgem, it is our view that Ofgem should use this opportunity to address any issues raised via previous consultations, such as the differences in the planning regimes in Scotland and England or the benefits of applying an early tender model against a late model.

SPT believes that the RIIO-2 process is the most appropriate way to facilitate a transparent consultation process in which all parties can participate. Competition should not be addressed via "the back door". The proposed CPM is neither competition nor efficient regulation. These are merely a distraction from what Ofgem should be concentrating on in RIIO-2 to ensure the long term interests of GB customers. Ofgem should ensure their priorities for RIIO-2 balances the interests of investors and customers.

III. Demonstrate the benefits case and proper risk assessment for applying either of the models, nor establish that these are better than the SWW mechanism available to it

To date, no cogent evidence has been presented to explain why the existing SWW mechanism should not continue. Ofgem's impact assessment accompanying its proposals is only 5 pages with little detail. This is clearly not adequate considering that our critical national infrastructure is being placed at risk.

Ofgem's analysis does not reflect the way the project would be treated under a project finance competitive model. The project would need to be viewed alongside investors' assessment of the project risks. Introducing regulatory uncertainty in relation to the funding of critical national infrastructure is not in the interest of UK consumers.

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. Ofgem's forecast are highly speculative, as the cost of capital that would materialise over a 45 year asset life period, as currently exists in the main price control, cannot be accurately forecast. Paragraph 3.41 of the consultation suggests that a cost of capital of 1.9% under RIIO over a 45 year period would need to be realised in order to deliver the equivalent level of savings identified by the top end of CEPA cost of capital ranges for HSB. Moving this high value project out of the main price controls to a 25 year term, removes the benefit regular price controls have to reset the cost of capital and incentives for network companies, potentially adding risk to consumers.

Ofgem's savings estimate is based on assumptions in the notional comparator about depreciation, gearing and tax allowances which are sensitive to small changes. There are alternative reasonable assumptions that would significantly reduce or eliminate the predicted savings. The estimate does not take account of possible changes from future price reviews under conventional regulation which would affect the comparator. In addition, the £293 million savings on financing costs are predicated on lower tax payments by licensees, which account for £161 million of those savings. The offshore transmission licensees are expected to pay less tax than the onshore comparator because they have more debt (higher gearing) and thus benefit from more tax relief on interest charges. Ofgem included this tax saving. However, this saving to consumers is likely to be matched by a corresponding additional cost to taxpayers.

The separation of new, large value assets from the regulated asset base of the network companies could result in increasing the overall cost of capital that is required to support the legacy asset costs. Overall, consumers will not necessarily benefit by introducing lower cost of capital models for individual projects.

The introduction of Competition Proxy or SPV models as proposed could result in the future transmission network to be low quality, unreliable and carry high operational costs ultimately costing consumers more money for a reduced service. We would also question whether the current HSB proposals would attract an investment grade credit rating as a standalone entity. We support the implementation of a competitive regime where we believe this will be value adding to the consumer. However, we believe that the proposed regime requires to be detailed and tested further before placing any of the GB critical infrastructure at risk.

IV. Establish a valid fact and market led case for the numbers they have estimated in relation to National Grid's cost of finance for this project

In relation to the proposed HSB Cost of Capital values, SPEN and SSE have jointly sought advice from NERA Economic Consultants who have advised that Ofgem's economic consultants CEPA have substantially underestimated the WACC for both the construction and the operational phases. Under the construction phase, CEPA understate the cost of equity based on understated Total Market Return (TMR) which places too much weight on CEPA's flawed Dividend Growth Model evidence. CEPA's estimates for the TMR do not reflect a balanced view of the available evidence. Furthermore, CEPA does not account for the proven inverse relationship between the equity risk premium and the risk-free rate.

CEPA bases its cost of capital ranges for the operational period on the assumption that the risks faced by the HSB project are similar to the risks of an OFTO. We consider onshore infrastructure operation is significantly different to an OFTO project. For example, there is significant exposure to onerous legal obligations – with potential for major fines – as well as greater output incentive exposure. The assets are in close proximity to end users. The impact on the network of unavailability of the HSB assets for any length of time could incur large constraint costs for the SO to constrain off the nuclear power station it is providing transmission access for. In addition, nuclear site licence obligations and related transmission licensee obligations also add further scrutiny on the network connections for the station.

The regulatory framework would not support the utilisation of HSB assets as collateral under a project finance approach. This is due to the fact that there is no mechanism in place to transfer or provide a licence to a new entity if it decides to enforce security against the assets. As a result, alternative financing mechanisms would be required which will result in significant costs, which will reduce any potential savings which Ofgem has forecast.

Investors require fair returns in order to ensure adequate investment in our networks. Ofgem has not made it clear what type of investor would be willing to invest in a project with a record low CoE of 2.5%-4.4%. Recent Private Finance Initiative (PFI) contracts in GB have highlighted that corners are cut to achieve adequate returns following the submission of low ball project bids. This has proven to be a disaster for some of our schools, so this risk must not be taken on our National Critical Infrastructure.

The lack of Cost Benefit Analysis, lack of a fair counterfactual and lack of robust financial justifications, all suggest that Ofgem has under-estimated the costs associated with either a SPV or CPM, therefore Ofgem has come to a flawed view of consumer benefit. Ofgem has a duty to further the protection of existing and future consumers. Ofgem must not act in haste and risk breaching its statutory duties.

As explained above, we are not convinced that Ofgem's proposals will produce sufficient returns to attract the required investment, therefore, there is a risk that there will be a material increase in costs to make the CPM viable. If Ofgem proceeds with the proposed terms, the HSB project may not be financeable and NGET may require to provide a cross subsidy to the HSB project utilising its wider balance sheet.

V. <u>Recognise it is reopening the National Grid TO price control via proposed framework it is "minded to" implement which is contrary to the public commitments Ofgem has unambiguously made about not reopening the RIIO-T1 price control.</u>

Moving away from the existing SWW mechanism towards a model that does not actually inject competition into the process, would be considered to be a reopening of the price control, which would have longer term implications in regards to investor confidence. Furthermore, as such high value projects are critical infrastructure, they should remain within the regulated price control framework.

At the outset of the RIIO-T1 price control, Ofgem proposed that major projects such as HSB would only be carried out via SWW at the RIIO Cost of Capital, or via a competitive process in which the TOs had the opportunity to decide whether they wished to take part in. It is not appropriate to mandate companies to deliver critical national infrastructure using untested financial parameters, in particular as Ofgem has not yet proven that the CPM or SPV will deliver savings for consumers.

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