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Dear James

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

Scottish Hydro Electric Transmission plc (SHE Transmission) welcomes the opportunity to respond to Ofgem's consultation on the Hinkley-Seabank (HSB) project: minded-to consultation on delivery model, published on 23rd January 2018. We agree with Ofgem's decision to approve National Grid Electricity Transmission (NGET)'s Final Needs Case for the HSB connection project. However, we do not agree with Ofgem's minded-to decision to apply the Competition Proxy Model (CPM) for the delivery of HSB. Furthermore, we strongly oppose the two alternative delivery models (CPM and SPV models) which Ofgem has developed, as the models are wrong in principle, lack evidence, the process in developing these models is insufficient and the merits of the models has not been demonstrated.

We note the contemporaneous publication by Ofgem of a document summarising its views on the future of competition within onshore transmission[1]. This update document does not provide for a timetabled response deadline, even though it sets out Ofgem's intention to consider the application of two alternative delivery models, the Competition Proxy Model (CPM) and the Special Purpose Vehicle (SPV) for all future Strategic Wider Works projects. This is subject to a Needs Case Assessment during RIIO-T1, which meet Ofgem's proposed Guidance on the Criteria for Competition[2], which in turn has not been formalised[3]. Ofgem has also recently published its RIIO2 Framework consultation[4] which seeks views from interested parties on the role of competition and the development of policy in that regard going forward. We intend to respond separately to the update document and the RIIO-2 framework consultation.

[1] https://www.ofgem.gov.uk/publications-and-updates/update-competition-onshore-electricity-transmission
[2] https://www.ofgem.gov.uk/system/files/docs/2018/01/draft_criteria_guidance.pdf
[3] In its update on competition in onshore electricity transmission publication Ofgem invites comments from stakeholders on the draft guidance but this is not made clear from the publication.
[4] https://www.ofgem.gov.uk/publications-and-updates/riio-2-framework-consultation

It is of significant concern to SHE Transmission that Ofgem is pursuing such a disjointed procedural approach to the development of a major policy change in an area that is of such importance to Transmission licensees (TOs), consumers and stakeholders. Certainty in the regulatory framework is vital for licensees, generators, customers and all relevant stakeholders including investors, particularly when this underpins the financing, construction and operation of new transmission assets. The need for regulatory certainty for all affected parties was recognised in the RIIO-T1 price control settlement for the eight year period 2013-2021 and was the rationale for the introduction of the Strategic Wider Works (SWW) uncertainty mechanism[5] which is subject to the same financial parameters as the broader control[6].

The HSB project has been submitted to Ofgem for consideration by National Grid Electricity Transmission (NGET) under the established SWW uncertainty mechanism. It is clearly a substantial discrete project, which meets the SWW assessment criteria. It has construction and financing challenges which are unique, as are the potential economic and social impacts on customers of its successful completion. We would strongly argue that Ofgem must consider each Needs Case proposal made under the SWW mechanism on its own particular merits, consistent with the RIIO-T1 settlement. SHE Transmission does not agree that either the CPM or the SPV represent a viable or legitimate alternative to the established SWW mechanism.

There has been no evidence presented as to why the SWW mechanism is not operating in the interests of licensees, existing and future consumers and wider stakeholders[7]. Moreover, Ofgem has not demonstrated the merits of applying the proposed alternative delivery models (SPV or CPM) to justify their implementation at this stage. The five page project-specific impact assessment accompanying this consultation cannot be considered to be adequate. Finally, there is a lack of clarity as to how Ofgem would determine that CPM or SPV should be adopted in relation to a SWW project. As such, it is our strong view that neither the CPM nor the SPV proposed alternative delivery models should be applied to the HSB project or any other SWW projects submitted to Ofgem for the remainder of the RIIO-T1 period.

Pending our response to the update document and RIIO-2 framework consultation, and because Ofgem has indicated that it may potentially seek to draw upon both its approach and its conclusions in relation to the HSB Needs Case when examining subsequent SWW projects submitted to it for consideration, our response to this consultation will indicate our fundamental objections to Ofgem's approach to the development of these alternative

[5] https://www.ofgem.gov.uk/electricity/transmission-networks/critical-investments/strategic-wider-works

[6] Appendix 2; p58; para 1.5 - RIIO-T1 Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd; 23 April 2012

[7] Appendix 2 (Critical Analysis) para 31

delivery models, which at this stage are not adequately developed in any event. They represent a marked contrast to the transparent, cross industry consultative process followed for the existing SWW mechanism or the CATO regime[8] until it was paused. Given the substantial differences between these models and the proposed CATO regime, it is inappropriate to translate the presumptive benefits of the CATO regime to these new models.

From the outset, it was always envisaged that any extension of competition in onshore transmission would be subject to Guidance from Parliament to Ofgem such that decisions taken would be consistent with wider Government energy policy and the public interest. There is a complete absence of a clear legislative and regulatory framework against which its merits can be judged, with the proper levels of scrutiny and challenge afforded by that process. Whilst it was understood in the RIIO-T1 Final Proposals that Ofgem may consider the role of third parties and the "use of a competitive process to award a TO the revenue stream needed to build, own and operate onshore electricity transmission assets". That was an apt description for the CATO programme, but neither of the proposed new models would fall within it.

SHE Transmission firmly believes that major policy change of this nature should not progress outside the established price control framework and without legislative amendment and scrutiny. Ofgem's description of what is "broadly representative of the processes"[9] that it will follow for assessing SWW projects is not sufficient to provide clarity for all interested parties as to how Ofgem will determine the most appropriate delivery model. As currently proposed, and under the auspices of a project specific consultation, Ofgem is now pursuing what can only be viewed as an unjustified reopening of the RIIO T-1 settlement, which it explicitly committed not to doing at the outset of the price control[10]. Our response focuses on the process followed thus far to reach this relatively immature stage of definition of the two models. We also comment on the proposed workings of the models, in so far as that is available, but highlight our concern that evidence and detail to describe the models is limited.

Our submission to this consultation comprises:

1. Appendix 1: Detailed comments in response to the HSB project: minded to consultation on delivery model and our views on Ofgem's overall approach in developing policy with regard to the extension of competition in onshore transmission
2. Appendix 2: Michael Fordham QC has undertaken a Critical Analysis of Ofgem's 'Competition' models. This paper describes why the imposition of CPM or SPV would be wrong in principle.

[8] Appendix 2 (Critical Analysis) para 15

[9] Update on competition in onshore electricity transmission Chapter 4 and the appendices

[10] See eg. RIIO-T1: Final Proposals for SPT and SHE Transmission, 23 April 2012, para 1.27

3. Appendix 3: We have commissioned jointly with Scottish Power Transmission (SPT) an independent report undertaken by NERA which sets out why Ofgem's proposed approach of using a CPM to set the WACC for HSB is itself unsound; notwithstanding the previous point that Ofgem's proposed re-opening of the WACC for the HSB project is unsound and even if Ofgem were to re-open the WACC, it should not rely on the CEPA analysis due to substantive errors and data inaccuracies.

In conclusion, SHE Transmission is firmly of the view that Ofgem must seriously reconsider its approach as outlined in the minded-to consultation. At this stage we must reserve our position regarding Ofgem's wider update in respect of competition in onshore transmission for the remainder of RIIO-T1, and any implications for any project with which SHE Transmission is concerned, especially given the significant change to the methodology of its implementation, the fragmented nature of the consultative process and the fact that we envisage responding to the update note separately.

Notwithstanding the serious concerns we have articulated in this submission, we remain supportive in principle of introducing new forms of competition but only where it is actual competition and can be clearly demonstrated that it delivers holistic benefits to energy consumers, the wider economy and supports the efficient, timely delivery of transmission infrastructure.

We believe that further policy development can be progressed within the wider context of Ofgem's RIIO-2 framework which can consider and design what, if any, future adjustments should be made to the SWW mechanism. To deviate from the SWW mechanism for the HSB by pursuing the Ofgem minded-to position would be disproportionate, represent a reopening of the price control, and creates severe disruption and uncertainty in the regulatory framework to the detriment of licensees, existing and future consumers, investors and other stakeholders.

We look forward to the opportunity to discuss our concerns with Ofgem in due course.

Yours sincerely

Katherine Marshall
Director of Regulation

Appendix 1: Detailed comments in response to the Hinkley-Seabank project: minded to consultation on delivery model and our views on Ofgem's overall approach in developing policy with regard to the introduction of competition in onshore transmission

1. The 'competition' models are unsound in principle.

1.1 We refer to Michael Fordham QC's Critical Analysis document, with which we agree and the contents of which we do not repeat.

1.2 Ofgem is contemplating the pursuit of two models for 'competition' in the delivery of a new transmission assets project. Each of them is unsound in principle. The context is provided by two points.

1.3 First, there is the RIIO-TI price control settlement. The industry is operating within a settled and stable price control, with limited powers of adjustment after a mid-period review, and with an established SWW uncertainty mechanism to determine what new revenue allowance should be paid to an incumbent licensed transmission owner when it can demonstrate the need for delivery of a new transmission assets project. Applying that price control mechanism, Ofgem takes account of any competition arising as a consequence of a statutory competitive tendering process held by the licensed TO for the supply chain, but does not mandate any such competition. Moreover, applying the mechanism, Ofgem will ensure consistent application of the financial parameters of the price control itself (such as cost of capital and asset life), consistent with its stated intent in the price control settlement.

1.4 Secondly, there is the competition extension programme. Ofgem and Government from 2000 to 2017 engaged with stakeholders on competition for licensed delivery of new transmission assets, as an alternative to the SWW mechanism. That meant a true competition familiar in nature (like OFTO for offshore assets), in which a third party could bid in an Ofgem-run competition to be the licensed deliverer of the new part of the transmission system, taking relevant licence and statutory duties, and receiving the revenue allowance. The design, industry-engagement, consultation and scrutiny for that option was sustained but incomplete. It was recognised that new statutory powers and further scrutiny would be needed. No one thought there was some other alternative to achieve 'competition' without such powers. This policy development was 'paused' in 2017, in lieu of Parliamentary time for necessary legislation.

1.5 Ofgem, in the HSB project-specific consultation, has proposed that it could use a 'proxy competition model' (CPM) in the name of its competition-promotion powers and in line with its previous indications about introducing a competition alternative to SWW. But CPM involves introducing no competition. It is instead a new model of 'proxy competition', when

'proxy competition' is already recognised as the very nature of regulated price control, including SWW. To adopt an alternative to SWW and call it CPM, thereby reopening the price control financial parameters (such as cost of capital and asset life), is purporting through a new label to do precisely what Ofgem cannot do under the settled price control. This in the name of a 'competition' that is non-existent. CPM is fake competition. It is and remains price control of the incumbent licensee TO, for the new transmission assets, precisely what SWW is designed to address.

1.6 As an alternative, Ofgem has considered for the HSB specific project that it could use a 'special purpose vehicle (SPV) model', in the name of its competition-promotion powers and in line with its previous indications about introducing a competition-introduction alternative to SWW. But the SPV model involves no competition for licensed delivery. There is no Ofgem-run competition. No party is competing to be licensed deliverer, with the deliverer's licence and statutory duties as recognised by Parliament. The incumbent transmission owner is and remains the licensed deliverer, owes the licence and statutory duties, and receives the revenue allowance. Here, the licensee is supposedly mandated to run a competition in transmission, something which is beyond the express design of the statutory competition duty which Parliament imposed on it[11]. It is to run this competition, without conferring any rights or responsibilities of a licensed transmission deliverer, the role and principled symmetry recognised by Parliament. It is supposed to become a mere conduit for a novel price control to a third party. No statutory power purports to permit this; nor does any licence provision; nor any price control instrument. SPV model is 'fronted' competition. Like CPM, it is and remains price control of the incumbent licensee TO, for the new transmission assets, precisely what SWW is designed to address.

1.7 Among the many problems with them, each of the two new 'competition' models is artificial. Each serves to circumvent an established mechanism by surrendering the stability of the very parameters to which SWW adheres. Each, in its own way, seeks to do through the back door what Ofgem cannot do through the front door: because it has not been given the necessary 'competition' statutory powers and because the express design of the RIIO-T1/SWW price control does not permit it. Neither is permissible. Neither was consulted upon. For six years, these were not put forward as viable alternatives to primary legislation for competition in licensed transmission. There has not been engagement with the industry as to them and their impacts and implications. Nor have they now been properly consulted upon or adequately impact assessed, including as to their suitability in principle or their implications in practice, midway through the RIIO-T1 price control settlement, or at all. No case has been made as to why the carefully designed SWW mechanism has become, through its deliberate parameters, somehow unfit for purpose to deal with new big transmission

[11] S9(2)

infrastructure projects and consumer interests. No alignment has been secured with Ofgem's thinking on the next price control, which is the obvious forum and opportunity for redesign. Ofgem is proceeding as though these two new models somehow fit within the past thinking and engagement on CATO, when they do not. Even if they did, that engagement has itself been demonstrably incomplete as to scrutiny, design and accountability. It would at least have culminated, prior to any implementation of a competition model, with having arrived at a very clear statutory, regulatory and commercial framework, each of which is absent here.

2. The PROCESS followed by Ofgem is wholly insufficient for such a significant change and will not allow for adequate levels of scrutiny or challenge to be applied.

2.1 It is not appropriate to implement such a major policy change through what should be a narrow assessment of a specific proposal under the SWW mechanism

2.1.1 Ofgem's principal objective[12] is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. Before Ofgem decides to carry out its function, in particular with a view to promoting competition, Ofgem has to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner in which it could carry out those functions which would better protect those interests. In carrying out these functions Ofgem must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

2.1.2 Accordingly, Ofgem has a very specific primary objective under statute; to protect the interest of existing and future consumers, and the interests of consumers are to be considered as a whole rather than solely focussed on consumer price or cost.

2.1.3 Under these primary obligations Ofgem developed the SWW uncertainty mechanism under RIIO-T1, to allow licensed Transmission Operators (TOs) to fund large capital projects delivering wider system benefits and replacing the previous TIRG and TII mechanisms[13]. The SWW mechanism has delivered a strong and transparent regulatory environment, within

[12] Section 3A of the Electricity Act 1989; other powers and duties for Ofgem are outlined in the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008, 2010 and 2011 as well as arising from directly effective European Community legislation.
[13] Appendix 2 (Critical Analysis) para 7

which Ofgem itself acknowledges that the TOs have performed well[14]. The SWW mechanism has facilitated the development of large infrastructure projects on time and close to budget. Within its RIIO-2 framework consultation[15] Ofgem proposes to maintain the SWW approach for dealing with work areas where there is uncertainty over the scope of work and the potential costs are significant for consumers. We agree with this approach.

2.1.4 However, we believe Ofgem is failing to meet its primary and secondary obligations through the development of these alternative delivery models. Ofgem has not complied with (or even addressed) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice. In addition to this, the standards of public law as to consultation[16] (including consideration of the consultation responses[17]) have not been adhered to, nor the standards of regulatory impact assessment.

2.1.5 It is of grave concern that the policy and delivery models are being developed by Ofgem specifically through the HSB project, but with the clearly stated intention that these delivery models would also apply to any future onshore transmission investments being developed under the SWW process which meet Ofgem's Guidance on the Criteria for Competition[18] (New, Separable and High Value). This approach serves to disenfranchise the wider group of affected stakeholders. It does not allow consideration of the applicability of the policy to projects of different geography, cost, technology, customer base or timescale.

2.1.6 In our view, neither the CPM nor the SPV are recognised regulatory models which have been subject to the appropriate levels of risk analysis, competition analysis and transparent consultation and scrutiny which are required prior to implementation[19].

2.2 Ofgem's development of competition

2.2.1 Ofgem provides an abridged history of how its proposed approach to competition has developed during the RIIO-T1 price control. The inference that the proposed alternative

[14] https://www.ofgem.gov.uk/system/files/docs/2017/12/riio_transmission_annual_report_2017_final_1.pdf
[15] Page 63; paragraph 6.28 - https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf
[16] Mosley v Haringey [2014] UKSC 56, explaining that the demands of fairness are likely to be higher when the consultation relates to a decision which is likely to deprive someone of an existing benefit.
[17] Page 42 - https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-minded-consultation-delivery-model.
[18] Published 23 January 2018
[19] See Figure 10 - https://www.nao.org.uk/wp-content/uploads/2012/06/121322.pdf

models can be considered a natural evolution of the CATO models is wholly incorrect. The CATO proposals were developed through a process of stakeholder engagement underpinned by a commitment from Ofgem to secure primary legislation[20]. Participation in the process by TOs was on the premise that the CATO final proposals would be subject to scrutiny and challenge in Parliament through a legislative process.

2.2.2 The point at which the Government decided not to proceed with the legislative process should not have been regarded by Ofgem as a situation calling for Ofgem seeking, informally and unilaterally, to impose new models alongside the price control arrangements. If Ofgem believes that competition can deliver significant benefits to customers then it cannot be appropriate to deliver such an important policy change through such a disjointed consultative process built loosely around the submission of the Hinkley-Seabank Needs Case for consideration under the SWW mechanism. This cannot be described to be regulatory due process.

2.2.3 Rather, Ofgem should have taken stock of the challenges posed by a non-legislative approach to extending competition, paused the process of policy development and engaged with the wider stakeholder community to best understand the concerns of affected stakeholders. It is incumbent on Ofgem, taking account of its statutory duties, to ensure that it conducts a clear and transparent consultation process in relation to the proposed delivery models, including a regulatory impact assessment and the opportunity for detailed scrutiny of the proposed delivery models. We firmly believe that the outcome of such a process would have seen a united approach to Government, with Transmission Operators and other stakeholders supporting Ofgem in a case for primary legislation.

2.2.4 We note that the HSB consultation includes an Impact Assessment (IA) in Appendix 3. This IA further strengthens our concerns regarding the process adopted by Ofgem in introducing these alternative models of delivery, as the IA has a very limited scope, and, coupled with the CEPA review, has predominantly focussed on costs rather than the interests of consumers more widely. It is therefore at odds, in our view, with Ofgem's principal objectives. Furthermore, Ofgem has placed an over-reliance on the Impact Assessment which was published to support the ITPR Final Conclusions. As outlined above, both the ITPR and ECIT projects were developed through a transparent process of stakeholder engagement underpinned by Ofgem's commitment to secure primary legislation. Therefore, the IA undertaken for the ITPR project is not directly relevant to the proposals of the alternative delivery models.

2.2.5 As outlined in our previous response to the HSB consultation submitted in October 2017, there has been no transparent, consultative and industry wide due process in the

[20] Page 12; Section 1.8 - https://www.ofgem.gov.uk/system/files/docs/2016/11/ecit_november_2016_decision.pdf

development of these new models. Therefore Ofgem has failed to engage with all the relevant key stakeholders in the development of these models and the two models which have been developed through the HSB consultations are not sufficiently developed to provide the appropriate regulatory certainty.

2.3 Ofgem has failed to provide either a process for assessing how the proposals are in the wider public interest or evidence that the proposals are in the public interest.

2.3.1 The so-called Criteria for Competition[21], referenced in Ofgem's "update" statement[22], is an incomplete check list. Critically, a decision on the suitability of a project for competition must be made subject to an evidence based test as to whether competition is the best interests of consumers and wider stakeholders. The process of delivering primary legislation would necessarily provide the scrutiny and challenge of proposals, as well as guidance for Ofgem on how it should act to further the best interests of consumers and other stakeholders in the delivery of the policy.

2.3.2 We appreciate that the decision to delay legislation was taken by Government, rather than Ofgem. But Ofgem's actions in pursuing remodelled price control arrangements, on a project-specific basis, is an inappropriate route. A pause in the current process would enable Ofgem and other stakeholders, including the Transmission Operators, to work together in engaging with Government on the need for primary legislation. It would also provide an opportunity for these issues identified in the 2016 legislative scrutiny[23] to be properly addressed:

1. Finalising the process such that it is clear how determinations are made in respect of whether and how to tender for onshore transmission.
2. Ensuring a level playing field for transmission projects across Great Britain
3. The requirement to address concerns with the potential regime and provide greater clarity
4. For further cost benefit analysis to ensure that value for money is central to any decision to take a project through the competitive tendering process. This would include the steps that Ofgem would be taking to mitigate the risk of delivery delays
5. Where projects meet the criteria for competition, the need for Ofgem to undertake project specific impact assessment of costs, benefits and risks

2.3.3 Ofgem itself recognised the need for legislative change to support its policy proposals in its Final Conclusions to the Integrated Transmission Planning and Regulation (ITPR) project in

[21] Published 23 January 2018
[22] https://www.ofgem.gov.uk/system/files/docs/2017/06/update_on_extending_competition_in_transmission.pdf
[23] Pre-legislative scrutiny of the Government's draft legislation on energy Sixth Report of Session 2015-2016, published 4 May 2016

March 2015[24]. The other examples quoted by Ofgem demonstrate the benefits of a competitive framework having all the required legislative underpinning, such as the Thames Tideway Tunnel project and Offshore Transmission (OFTOs) regime.

2.3.4 It is apparent that both the Thames Tideway Tunnel project and the OFTO regime[25] operate within a recognised regulatory framework which has been developed via the correct mechanisms following the legislative process[26] and subsequent consultations. These schemes both mitigate the risks involved with regulatory uncertainty and encourage investment in industry[27].

2.3.5 The benefits of competition were recently considered in another regulated industry by the Hansford Review[28]. Some of Hansford's observations can be read-over to the transmission sector. The report's recommendation states that Network Rail and the government should develop clear and transparent principles for considering contestability at each investment decision stage. We suggest that this approach should be adopted by Ofgem.

2.4 The proposal to implement competition in this manner undermines the RIIO-T1 settlement

2.4.1 Ofgem must also consider the potential impact which the development of these alternative delivery models will have on the current RIIO-T1 price control settlement. We believe these solutions are not appropriate at this time and the prospect of their implementation on mature projects could lead to protracted regulatory process (including potential formal challenge) risking significant delays to the delivery programme to the detriment of connecting generators and ultimately customers.

2.4.2 Ofgem, after following a long, clear and transparent consultative process, carefully developed the SWW mechanism as part of that RIIO-T1 regulatory framework to allow the TOs to bring forward, supported by a Needs Case, proposals to construct, operate and maintain new large transmission projects and seek approval for funding under the same

[24] Integrated Transmission Planning and Regulation (ITPR) Project: Final Conclusions, March 2015
[25] In 2011, the EU Third Energy Package was implemented in the UK through the Electricity and Gas (Internal Markets) Regulations 2011 (2011 Regulations).
[26] The Flood and Water Management Act 2010 amended the Water Industry Act 1991 ("the Act") by inserting a new Part 2A, which conferred powers on the Secretary of State to make regulations about the provision of infrastructure for the use of water undertakers or sewerage undertakers.
[27] Appendix 2 (Critical Analysis) para 37
[28] Unlocking rail investment – building confidence, reducing costs (June 2017), published 31 July 2017. https://16cbgt3sbwr8204sf92da3xxc5mwpengine.netdna-ssl.com/wp-content/uploads/2017/07/TheHansford-Review.pdf; also Sir Peter Hendy commenting on the purpose of the Hansford Review in a Press Release dated 16 March 2017. http://www.riagb.org.uk/wp-content/uploads/news-documents/Hansford-Review.pdf.

financial parameters. This mechanism protects the interests of existing and future consumers and promoted competition to the extent appropriate, consistent with the TOs' own statutory duties as licensees to develop and maintain an efficient, coordinated and economical transmission system, facilitating supply and generation competition. The consequences for non-delivery under this mechanism are transparent and accountability is clear. Furthermore, this mechanism is sufficiently flexible such that the TO is able to seek to integrate local issues for the reinforcement - for example in the case of HSB, the T-pylon and for the Orkney project the development of the alternative approach.

2.4.3 The SWW mechanism is underpinned by supporting guidance, and provides certainty over the approach to be taken for TOs, Ofgem when considering these large new projects, connecting generators, customers and other stakeholders. Reinforcements likely to be subject to the SWW mechanism are clearly identifiable in connection agreements where the incumbent TO has the obligation to deliver to meet the contracted connection date. The financial parameters for SWW projects are consistent with RIIO-T1 price control in terms of asset life, the cost of capital and the totex incentive mechanism. Customers share in the benefits of a TO's outperformance. Critically, from a financeability perspective in particular, they are understood by investors, whilst also affording protection for existing and future consumers as the financial parameters can be revisited in the round as part of the future price control process.

2.4.4 Ofgem has provided no evidence, still less assessment, to suggest that this regime is not working or is failing to deliver for licensees and consumers. For this reason alone, an intervention of this nature cannot be justified. In fact, under the SWW uncertainty mechanism, needs cases and project assessments have been submitted to Ofgem by the TOs during RIIO-T1 for approval. Ofgem's process scrutinised and challenged these, taking account of all relevant considerations, including project drivers, technical and operational options, modelling assumptions, efficiency, costs and the allocation of project risk. In addition, customers and other stakeholders have been and are encouraged to participate in the assessment process. As such, the SWW mechanism demonstrably works and has facilitated the construction and timely delivery of large onshore transmission projects such as the Kintyre-Hunterston project, to the benefit of consumers, existing and future and supported competition in electricity generation and supply.

2.4.5 As we will describe elsewhere in our response, the CPM model reopens the price control. As proposed, and were it to be implemented, the CPM would reduce significantly the Cost of Capital and introduce a 25 year contract for transmission assets with a much longer asset life.

2.5 Amendments to the SWW framework should be pursued as part of the development of the RIIO-2 framework

2.5.1 We believe that the adoption of an alternative approach to the SWW uncertainty mechanism can only be considered to be a reopening of the price control and its parameters, which will undermine investor and stakeholder confidence, with all the consequential adverse effects on TOs, consumers and other interested parties. The effect of implementing Ofgem's alternative delivery models would be to remove, and indeed isolate these high value assets, which are critical infrastructure, from the protection of the price control. Without this protection, risks are increased for existing and future customers who ultimately benefit from these investments. Ofgem asserts in its Impact Assessment that investors should not view the cost of capital assumptions for the application of CPM to HSB as an indicator for what to expect in RIIO2.

2.5.2 Outlined in this response and in the accompanying Critical Analysis are our concerns with the approach that has been adopted to the development of Ofgem's competition policy. We feel that Ofgem has singularly failed to develop its proposed alternative delivery models in a clear and transparent manner, unlike its approach previously to the CATO regime. It is of note that there now appears to be a multiple workstream approach which cuts across the ongoing work to develop the RIIO-2 framework. We firmly believe that the RIIO2 process is the most appropriate way to facilitate a transparent and robust consultation process in which all parties can participate. The most appropriate course of action for Ofgem to further pursue alternatives to SWW must be as part of the development of the RIIO2 framework and the detailed sector-specific work.

2.5.3 In the meantime, Ofgem should continue to utilise the current, well understood and proven SWW mechanism for any immediate projects progressed during the RIIO-T1 period.

3. The MERITS of introducing these models (compared to the RIIO counterfactual) has not been demonstrated and, in particular, the EVIDENCE used to assess potential benefits to current and future customers is flawed and incomplete and, hence, likely to lead to unintended consequences.

3.1 *No evidence that the costs are high*

3.1.1 Ofgem has failed to demonstrate the merits of introducing these alternative delivery models relative to the SWW counterfactual. In particular, the evidence used to assess the potential benefits to current and future customers[29] is flawed and incomplete and therefore highly likely to lead to unintended consequences. We would challenge Ofgem to present evidence to support its view that the existing costs under the RIIO-T1 current arrangements are excessive. The purpose of a price control process is to assess the level of costs through comprehensive cost benchmarking and analysis, something which Ofgem is about to

[29] https://www.ofgem.gov.uk/system/files/docs/2018/01/cepareport_newassets_23jan2018.pdf

undertake as part of its RIIO-2 framework consultation and subsequent processes in advance of RIIO-T2 commencing.

3.2 *No evidence that the SWW mechanism is failing consumers*

3.2.1 Furthermore, Ofgem's 2016-17 annual report demonstrates the success of the current RIIO-T1 price control and the SWW mechanism. It is of note that two out of the three SWW projects approved so far have been delivered ahead of schedule and the third, Caithness-Moray, is still ongoing. This lack of evidence begs the question of what is the problem which Ofgem is trying to resolve? Compared with the SWW counterfactual, Ofgem must be able to evidence that the costs associated with developing these alternative delivery models and the subsequent implementation are clearly outweighed by long-term benefits to consumers. The SWW mechanism developed in RIIO-1 has delivered a strong and transparent regulatory environment, within which Ofgem itself acknowledges[30] that the TOs have performed well regularly delivering large infrastructure projects on time and close to budget. This can be demonstrated through the Project Assessments undertaken by independent consultants appointed by Ofgem who review the relevant SWW Needs Case and Project Assessments.

3.3 *Existing regulation including the SWW mechanism mandates competitive procurement*

3.3.1 Ofgem implies that it wishes to change the behaviour of NGET as it will be applying the SWW approach to contractual risk. Whilst Ofgem may consider this approach to be less favourable, it has never been stated within publications or even the recently published 2017 SWW Guidance that a TO must demonstrate this change in behaviour.[31] Transmission Owners are subject to existing regulation which mandates competitive procurement[32]. The Project Assessment process which sets the revenue allowed for SWW projects requires the licensee to include evidence demonstrating to Ofgem that efficient costs will be incurred.[33] Where necessary, an open book process to allow examination of key competitively procured contracts can be undertaken. The majority of capital costs for Transmission owners are already the result of a statutory competitive procurement exercise. Indeed, for SHE Transmission over 80% of capital costs are the result of a competitive exercise. Ofgem has not presented any evidence to show that these competitive processes are failing and how its

[30] https://www.ofgem.gov.uk/system/files/docs/2017/12/riio_transmission_annual_report_2017_final_1.pdf
[31] Section 3.51 page 26 - https://www.ofgem.gov.uk/publications-and-updates/hinkley-seabank-minded-consultation-delivery-model.
[32] SHE Transmission is subject to 'The Utilities Contracts (Scotland) Regulations 2016' and SpL6I.36
[33] Appendix 2 (Critical Analysis) para 9

insufficiently developed alternative delivery models would address this to the benefit of existing and future consumers.

3.4 *Poorly justified Cost Benefits Analysis*

3.4.1 As outlined above, the SWW mechanism was designed to achieve the same outcome that Ofgem would be appearing to try to achieve through CPM and SPV. Ofgem currently sets the cost allowance for transmission licensees and we are not aware of any evidence demonstrating that these costs are high or that transmission licensees are inefficient. The CPM approach still requires Ofgem[34] to set the cost allowances and as we have highlighted in our overall response, the cost of capital is not subject to be re-opened as part of RIIO-T1.

3.4.2 The nature of running a real competition means that the true capital and operating costs will be revealed alongside the cost of capital - something which the proposed models do not provide. The SPV model also suffers from the same failings, whereby Ofgem identifies a supposed "cost saving" to consumers by using a flawed benchmark for the cost of capital[35] (see 3.14 to 3.19 below) and asserting (not evidencing) the capital costs would be 10% lower and the operating costs would be 5% lower as a result of the SPV model. However, there is no evidence this would be the case since the OFTO benchmark used was for constructed assets, and Ofgem has no counterfactual to assess operating costs. Ofgem sets out in its OFTO cost assessment guidance[36] that it did not assess the operating costs as it was "not considered with the scope of the cost of developing and constructing transmission assets"[37]. On this basis, Ofgem cannot draw on evidence it has not assessed to conclude the impact of these alternative models on operating costs. Furthermore, in Ofgem's RIIO-2 Framework Consultation, it concluded[38] that a shorter price control of five years (compared to current 8-year RIIO-1 price control) would be more appropriate for setting allowances, which recognises the uncertainty of network companies' ability to forecast accurately over the longer period. This appears inconsistent with Ofgem's conclusion that companies will be able

[34] Page 20; para 5.6 - https://www.ofgem.gov.uk/system/files/docs/2018/01/competition_update.pdf

[35] The SPV model would derive a cost of capital based on an assessment of the capital and operating costs by Ofgem followed by a bid revenue stream from the "delivery agreement". The estimation of the cost of capital and the capital and legal structure of SPV are incomparable to current arrangements and are different to OFTOs. No conclusions can be reliably drawn without further evidence and analysis.

[36] https://www.ofgem.gov.uk/system/files/docs/2017/07/170629_update_cost_assessment_guidance__0.pdf

[37] Page 15; para 2.44 - https://www.ofgem.gov.uk/system/files/docs/2017/07/170629_update_cost_assessment_guidance__0.pdf

[38] Page 8; para 1.8; and page 30; para 4.22 - https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf

to forecast their operational costs for a period of 20-25 years with more certainty, thereby leading to savings for consumers. Again, without evidence, we see no basis for Ofgem's assertion on operational costs savings under the SPV model.

3.5 *Contradicts economic theory*

3.5.1 Ofgem is contradicting economic theory by asserting that a single asset owner will be able to generate cost savings through an SPV model when it will be unlikely to benefit from economies of scale. This does not take account of the fact that Ofgem has failed so far to develop in either of these models suitable approaches to deal with the legal and contractual issues that arise as a result of these complex structural and contractual arrangements including the allocation of risks and liabilities.

3.6 *Failure to consider important issues for customers and focus specifically on costs only*

3.6.1 In addition to the lack of evidence of the current costs under the RIIO-T1 framework, we note that Ofgem's development of a competitive framework in onshore transmission has been focussed on cost reduction only. Ofgem's key finding from the ITPR Final Conclusions was to "bring capital and operational cost savings", demonstrating that Ofgem has been fundamentally driven by cost reductions only. This should not be the only consideration for Ofgem, which must take account of its wider statutory objectives. Consistent with our position stated above, Ofgem must therefore examine other key factors which may be in the broader interest of consumers, such as customer service, security of supply or environmental impact as part of the development of alternative models to the SWW mechanism.

3.7 *Inadequate Impact Assessment*

3.7.1 Ofgem's own Impact Assessment Guidance[39] (October 2016) expects that IAs will be a rigorous tool and so consider "the potential impact of regulatory proposals on matters such as the interests of consumers, industry participants, competition, and on social and environmental issues". The wider social and environmental implications of the proposal would be explicitly considered, even when hard to monetise; in this case we might have expected Ofgem to explore, for the CPM, the wider social impacts of the assumed project financing model and tax assumptions (see para 3.12 to 3.14 below). For the SPV model, such considerations might have extended to the impact of this proposal on the end customers such as the timing of the infrastructure delivery, the responsibility and accountability for such delivery and the future obligations to ensure reliable and secure operation of the asset. IAs are iterative tools, that develop and evolve as the policy is established and evidence is revealed through the consultation process. This, we believe, is the first and only IA for the

[39] https://www.ofgem.gov.uk/system/files/docs/2016/10/impact_assessment_guidance_0.pdf

CPM and SPV models, produced at "minded to" stage without the full detail of the models being available. As we describe elsewhere, we have real concerns about the purported basis of the assumptions that input to this IA. Adjusting for the evidence that we present here, and others might provide in response to this consultation, is likely to materially impact upon the IA. Considering this, and the undue restriction in scope of the IA, it is our view that this five-page IA cannot be considered to be adequate for this important policy decision.

3.8 *Ofgem's estimates of transaction costs for introducing CPM are low and do not reflect the nature of competition.*

3.8.1 Ofgem has failed to estimate the transaction costs for running a "competition" as it has described both the CPM and SPV models at just £0.3m when the likely costs will be not just materially higher but profoundly higher than it has estimated. Considering the legal costs, consultancy fees, internal staff costs and ignoring the extensive procurement process and related costs it is our view, and that of NERA, that the numbers proposed by Ofgem are unsound. In the absence of running a true competition or undertaking a robust enough IA, Ofgem has failed to fully calculate the transaction costs for its proposed delivery models. Ofgem has not identified any material dis-benefits of either delivery model such as the extended regulatory process, additional costs of the regulatory process and potential for delay.

3.9 *OFTOs are an inappropriate and flawed benchmark (for costs).*

3.9.1 The IA undertaken by Ofgem has been focussed on costs only and has not been validated with any evidence, such as an example of a competitive process. Instead, Ofgem has used the competitive framework used in offshore transmission (OFTOs) as a benchmark to reach its conclusions that it will apply competition to onshore transmission. However, it is fundamental point of principle that the OFTO market is not an appropriate benchmark or precedent to use for the development of competition in onshore transmission. OFTOs are not the same as onshore transmission licensees: they do not have the same obligations to develop and build the offshore assets; they only adopt the assets once they have been built and commissioned. Their risk profile is completely different to that of an onshore TO who bears the construction and delivery risk, something which translates into their cost of capital (see NERA). Furthermore, as KMPG pointed out in a July 2015 report for SHE Transmission[40] (p.9) a National Audit Office report in 2012 had "noted that OFTO competitions would enable Ofgem to 'develop a database of useful cost information which it can use to inform base cost

[40] July 2015; KPMG – The introduction of competition into Onshore Electricity Transmission, report prepared for SHE Transmission

levels and efficiency assumptions when it sets prices for onshore electricity transmission every eight years'."

3.10 *Asset Lives changing to 25 years.*

3.10.1 Ofgem has failed to articulate or justify the departure in their current asset life policy for TOs which is transitioning from a period of 20 years to 45 years. In the development of the RIIO price control, Ofgem reconsidered the appropriate level of 'asset lives' for the purpose of calculating depreciation and after a prolonged consultation period Ofgem opted to follow a 45 year asset life for RIIO-T1 and RIIO-ED1. Asset lives have an impact on prices for regulated services, as they represent the period over which investors are repaid for investments in new regulated assets. Shorter asset lives mean that consumers repay investors faster. This has a long-term timing effect (i.e. an intergenerational effect); it means higher bills in the short term, but lower bills in the long term.

3.10.2 The proposed models both advocate a 25 year asset life which Ofgem argues is to suit the project financing nature of the proposed arrangements. Ofgem does not consider in its analysis the impact on current and future consumers, which it has a statutory duty to protect and balance their respective interests. In the British Gas Appeal in 2015 to the CMA in relation to the Slow Track Distribution Network Operators (DNOs)[41] Ofgem defended its own policy for transitioning to a 45 year asset life. Ofgem did not at any point argue that a shorter asset life was more appropriate. By opting for a 25 year asset life, Ofgem is accelerating the charges to current consumers to the benefit of future consumers assuming the asset will not need to be replaced shortly after the 25 year period has expired. In the absence of any analysis or justification as to the impact on consumers, this policy change is not justified and even in Ofgem's RIIO-2 Framework Consultation[42] concludes that it does not intend to revisit the asset life policy albeit it welcomes views.

3.11 *Incentives and obligations to maintain the asset are unbalanced and unclear*

3.11.1 It is inconsistent that in the development of these alternative delivery models Ofgem has also adopted a regulatory period which is much shorter than the CMA endorsed 45-year

[41] This was part of the British Gas Appeal in 2015. See ground 4 as per CMA FD p122 https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf

[42] Page 99, section 7.99 - https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf

asset life[43]. Such an assumption creates a disincentive to maintain the asset more than the minimum required standards and there is a strong likelihood of increasing operational cost estimates instead of decreasing them due to the lack of re-openers and re-set mechanisms. This was a flaw present in the previous CATO model that was not resolved prior to being 'paused'. However, for the CPM and SPV models, the obligations and incentives are ambiguous and in substance it appears that the incumbent TO will be responsible for ensuring that the assets are constructed and maintained in line with the required standards and time periods. In the sense of true competition, the TO would have the choice of whether to compete at the rates and costs being bid whereas for CPM these are being imposed, and for SPV the obligations are being imposed to ensure a contractual party is delivering the required standards. The TO's ability to earn a suitable risk assessed return is simply not articulated and the balance of risk and reward particularly in asset stewardship is completely ignored by Ofgem. The incentives estimated for an SPV are based on an Ofgem assessment of the counterfactual which it would not be able to estimate without the competition being run. This illustrates the lack of clarity and definition available and will require comprehensive analysis, consultation and refinement even if this model were considered appropriate.

3.12 *The National Audit Office (NAO) Report on "Offshore electricity transmission: a new model for delivering infrastructure"*

3.12.1 The National Audit Office (NAO) Report on "Offshore electricity transmission: a new model for delivering infrastructure" in June 2012[44] recognised that the savings estimates cited by Ofgem were not clear. This is because the estimates made assumptions in the notional comparator about depreciation, gearing and tax allowances which are sensitive to small changes. The NAO also concluded that the estimated savings did not take account of the impact of possible changes arising from future price reviews which would affect the comparator. OFTOs have unique corporate structures to enable specific and reduced tax arrangements compared with onshore licensees. Thus whilst there would be a saving on financing costs that would be passed on to consumers NAO believed that there would also be a corresponding additional cost which would be funded by taxpayers[45] as summarised below:

> *"3.18 In our view, the Authority's savings estimate is not clear for the following reasons:*

[43] This was part of the British Gas Appeal in 2015. See ground 4 as per CMA FD p122 https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf

[44] https://www.nao.org.uk/wp-content/uploads/2012/06/121322.pdf

[45] Para 3.18 NAO (June 2012), Offshore electricity transmission: a new model for delivering infrastructure

> • *The estimate is based on assumptions in the notional comparator about depreciation, gearing and tax allowances which are sensitive to small changes.* ***In our view, there are alternative reasonable assumptions that would significantly reduce or eliminate the predicted savings [emphasis added]****.*
>
> • *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.* ***The Authority included this tax saving as its remit is to consider the impact on consumers. However, this saving to consumers is likely to be matched by a corresponding additional cost to taxpayers [emphasis added].”***

3.12.2 This supports the case that Ofgem's specific analysis and assumptions require further scrutiny and evidence and also adopts a specific and singular focus. In Ofgem's RIIO-2 Framework Conslutation it is noted that[46] *"In an appendix to the UKRN draft, Frontier Economics refer to tax arbitrage as a potential factor driving RAV transaction premiums*" which Ofgem does not explore in its analysis of OFTOs, whereby it may be that the headline lower cost of capital is due to tax arbitrage. In the absence of further evidence or analysis, even if tax were deemed an appropriate saving with no net costs to consumers (who are taxpayers) this is not a position TOs find themselves in which would apply under CPM and SPV models.

3.13 *The cost of capital estimates are fundamentally flawed*

3.13.1 We commissioned NERA to review the cost of capital estimates for the proposed competition models[47]. There are a number of flaws in the analysis presented by Ofgem and CEPA, whereby they fundamentally understate the construction and operational WACC for HSB due to errors and inaccuracies. NERA concluded that *"even if Ofgem were to re-open the WACC [in the price control], it should not rely on CEPA's analysis"*. NERA's view is that CEPA has estimated a *'corrected construction vanilla WACC of 4.0 to 4.4 per cent for HSB'* compared to CEPA's 1.12 to 2.7% estimate. Similarly NERA have calculated an *"operational vanilla WACC*

[46] Page 98; footnote 101 - https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf

[47] See NERA *Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments*

of 3.1 to 3.7 per cent for HSB" compared to CEPA's calculation of 0.6% to 1.75%[48]. Therefore when considering the impact on Ofgem's CBA that underpins its justification for HSB, the calculated savings to consumers is eliminated. NERA has set out flaws in CEPA's estimate which is consistent with previous evidence on setting the appropriate WACC for Regulated Networks[49]. Setting the WACC should not be required if either model was a true competition as this would be revealed as part of the process. In the absence of competition, Ofgem cannot rely on the CEPA analysis to reach a conclusion on setting the cost of capital, even if it were to re-open the price control[50]. NERA also identifies a number of other adjustments required such as the application of the gearing assumption based on construction comparators and use of spot rates on the Risk free Rate compared to forward rates which indicate the increase in government bond yields over time.

3.14 *Estimates contrary to regulatory precedents*

3.14.1 When calculating the estimates for cost of equity the use of certain types of evidence in isolation places more weight on short term evidence despite substantial contradictory evidence and regulatory precedent. NERA highlights that CEPA has used selective inputs for the Dividend Growth Model (DGM) which are inconsistent with evidence from the Bank of England. Separately to this, CEPA places little weight on the long run market evidence through estimating the Total Market Returns (TMR) as an input into the Capital Asset Pricing Model (CAPM). This is a well recognised framework for estimating the cost of equity particularly over long periods of time where there is typically mean reversion. The CEPA methodology is contradictory to Ofgem's stated position in the RIIO-2 Framework Consultation where it seeks to use the CAPM and not the DGM, and also notes that the cost of equity is unobservable[51]. In other areas where CEPA has diverted from previous regulatory precedent includes the use of the geometric mean instead of the arithmetic mean which is inconsistent with Ofgem's previous approaches in setting the components of the cost of equity and that of the CMA. The geometric mean provides a materially lower answer on the cost of equity than the arithmetic mean.

3.15 *Selective use of data for benchmarking or that cannot be reconstituted*

[48] All numbers presented in this paragraph are real (RPI deflated)
[49] Oxera "The cost of equity for RIIO-2: A review of the evidence" prepared for ENA http://www.energynetworks.org/assets/files/info/Oxera%20research%20on%20the%20cost%20of%20equity_2018-02-28.pdf
[50] Appendix 2 (Critical Analysis)
[51] Page 83, para 7.30 and 7.33 https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf

3.15.1 NERA highlights that CEPA has estimated the asset beta (an input into a component of the CAPM through the equity beta) in a selective manner for the construction phase of HSB. NERA highlights that it was unable to replicate CEPA's analysis and when undertaking its own analysis including excluding illiquid construction comparators it has a significantly higher asset beta leading to a higher cost of equity. NERA has also highlighted that CEPA has relied on the implied nominal equity IRRs for OFTOs but fails to provide any evidence, or indeed explanation under, what assumptions the equity IRRs are derived. In the absence of this information it is not possible to reliably estimate the equity IRRs. Similarly, NERA highlights that the NAO estimates a higher equity IRR[52] which CEPA incorrectly references in its own cost of equity analysis[53]. Without this evidence it is not possible to draw conclusions on the CPM or SPV using OFTO inference.

3.16 *Use of qualitative judgement and not evidence-based to reach conclusions*

3.16.1 CEPA has employed qualitative judgement on the level of risk associated with OFTOs, interconnectors and CPM without adequate justification. As stated earlier, OFTOs and interconnectors are not directly comparable with onshore transmission assets and infrastructure. Finally, CEPA's conclusions do not have any analysis or evidence to support its conclusions and given it has utilised inappropriate and incomplete benchmark data so reliance should not be placed on its qualitative conclusions.

3.17 *Costs of debt are materially understated*

3.17.1 NERA identifies that CEPA has materially underestimated the cost of debt in its calculations through setting the benchmark credit rating higher than would be achievable (A/BBB). CEPA ignores precedents such as the Thames Tideway Tunnel (TTT) project which was designated as a BBB credit rating and benefits from a number of government guarantees and protections. NERA also argues that CEPA has misestimated the issuance costs and cost of carry in its analysis while it assumes that all financing will be raised at the outset of the project construction phase. NERA also identifies flaws in CEPA's estimate for the costs of debt during the operational phase.

3.18 *Proposed SPV models are not financeable*

3.18.1 The impact on Credit Ratings and existing regulatory ring-fencing requirements has been ignored in CEPA's analysis for CPM in arriving at its analysis and also considering the impact on the financeability and credit metrics for an SPV model. This is in essence an off-balance sheet arrangement that would fall into the realms of IFRS 16 Operating Leases

[52] NAO (June 2012); Offshore electricity transmission: a new model for delivering infrastructure; p.29.
[53] CEPA (January 2018); Review of cost of capital ranges for new assets for Ofgem's networks division; p.54.

whereby the liabilities would reside with the TO and project financing would simply not be available.

3.19 CONCLUSIONS

3.19.1 We therefore have significant concerns with the approach used by Ofgem and its consultants (CEPA) to achieve these estimated financing savings which are outlined in further detail below. Our concerns are corroborated by the independent report by NERA which accompanies this submission. As we have intimated elsewhere in our response, the most appropriate way forward for considering this model would be to examine it under the umbrella of the RIIO-2 Framework. This consultation is for decision on scope in the summer, with detailed implementation in the sector-specific work. We see no justification for Ofgem to be running two processes in parallel.

3.19.2 **CPM model is underdeveloped and inadequately justified.** As outlined above and in Appendix 2 Critical Analysis[54], SSEN is not supportive of the Competition Proxy Model as it cannot be considered to be replicating efficient competition (which is covered fully in that document). Furthermore, to adopt this under-developed model contradicts existing TO licence obligations to develop an efficient, coordinated approach to the development of its system. This risks unintended consequences such as poorly constructed, unreliable system characterised by high operating costs which would be at odds with the principles underpinning RIIO. This risk is not, in our view, comparable with that faced by an OFTO.

3.19.3 **The CPM is not supported by a robust impact assessment.** In its limited Impact Assessment[55] Ofgem states that its analysis "indicates that pursuing the Competition Proxy or SPV delivery model *may deliver* greater consumer benefit than the status quo RIIO (SWW) arrangements". The rationale is that lower costs of financing HSB would be realised through this alternative CPM approach which is not robust and does not stand up to scrutiny[56]. Instead, what has been developed is essentially a simplistic financing saving derived from the setting of a stand alone Weighted average cost of capital (WACC) for onshore transmission projects.

3.19.4 **The SPV model is a complex and underdeveloped alternative 'back-door' to competition delivery model.** Currently there is significant uncertainty attached to the SPV

[54] Appendix 2 (Critical Analysis) para 26-31
[55] See Appendix 3 of Ofgem's 'Minded to' consultation on HSB; https://www.ofgem.gov.uk/system/files/docs/2018/01/hsb_condoc_delivery_model.pdf
[56] See NERA *Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments*

model as there is no contractual or regulatory policy framework. Ofgem itself[57] [58] acknowledges that a significant amount of work is needed to finalise these, including:

- Determining the incentives and obligations for a TO to deliver a tender;
- Confirming the allocation of risk between the TO, SPV and consumers
- Regulatory arrangements required to provide certainty and clarity to Networks, Investors, consumers, and bidding parties.
- The scope and key parameters of the tender itself
- Decision making processes to secure timely delivery of a project via the SPV model

3.19.5 Until these elements are developed and concluded, and there is greater clarity regarding the relationship between the TO and SPV it would not be appropriate to implement this for HSB or any other SWW project and we cannot see how it is practicable to progress in parallel.

3.19.6 In order to further develop the SPV model, the process must be open and transparent otherwise it will lead to sub-optimal outcomes. We consider that it would most appropriate for Ofgem to develop this model under the RIIO-2 Framework in the absence of legislation.

3.19.7 It is of note that previous responses to Ofgem's consultation on the HSB needs case highlighted that the introduction of tendering processes via the untried SPV approach would bring significant and unnecessary delivery risk at such a late stage in this specific project and would distract NGET from meeting its wider obligations[59]. Given the time that it would take to develop an optimum SPV model we do not see how this can be achieved without jeopardising the project timetables which would adversely affect customers, for example, delivery of HSB meet EDF's connection date.

4. SSEN's response to Ofgem's specific questions posed in the HSB minded-to consultation

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

For the reasons outlined throughout our submissions to this consultation we do not agree with Ofgem's minded-to position.

[57] Page 27; para 3.55 - https://www.ofgem.gov.uk/system/files/docs/2018/01/hsb_condoc_delivery_model.pdf
[58] Ofgem's update on competition p7 - https://www.ofgem.gov.uk/system/files/docs/2018/01/competition_update.pdf
[59] Page 28; para 3.60 - https://www.ofgem.gov.uk/system/files/docs/2018/01/hsb_condoc_delivery_model.pdf

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?

Reopening cost of capital is wrong in principle. Moreover, as we do not believe that the CEPA work is robust, we believe that the cost of capital ranges are highly inappropriate. The independent report we have commissioned from NERA to examine the CEPA methodology sets out the inadequacies of the approach in detail.

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

On the cost side, Ofgem has not confronted the many flaws in the model and its adoption. As we have explained elsewhere we see no benefits arising from the proposed model that are not already provided for in the existing SWW mechanism. We consider that Ofgem's assessment has been narrowly focused and has ignored the wider benefits afforded by the existing regime.

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?

We do not agree with the proposed approach and believe that it should follow the RIIO-1 financial parameters.

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

The independent report we have commissioned from NERA to examine the CEPA methodology sets out the inadequacies of the approach in detail.

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

We see no reasons for Ofgem to deviate from the tried and tested SWW Project Assessment Approach. To do so is wrong in principle, unjustifiable and unmerited.

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

We consider that a fundamental risk with the proposal is that it cannot deal with uncertainty.

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?

We have explained in detail why we believe that the HSB project should proceed under the RIIO-T1 SWW mechanism and we believe the models being developed are significantly different to the policies being developed under the RIIO-2 Framework.