Appendix 2

SSE'S HINKLEY SEABANK CONSULTATION

CRITICAL ANALYSIS OF OFGEM'S 'COMPETITION' MODELS

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The RIIO-T1 Price Control Context

1. **Transmission licensees and their statutory duties.** The starting point for the analysis is that onshore Transmission Owners (TOs) hold statutorily-required transmission licences (TLs) (EA 89 s.6(1)(b)) and, because they are licensees, owe enforceable duties under their licences together with accompanying statutory duties: (1) to develop and maintain efficient, coordinated and economical transmission systems (s.9(2)(a)); and (2) to facilitate competition in generation and supply (s.9(2)(b)). A third party non-licensee will owe no duties under any licence or under this important statutory provision.

2. **The regulator's statutory duties.** Ofgem as regulator is required to act in pursuit of its own statutory duties. For present purposes that includes: (1) to act as best calculated to further the protection of existing and future consumers, and (2) wherever appropriate to do so by promoting effective competition between those commercially concerned with electricity transmission, supply or distribution (EA 89 s.3A).

3. **The RIIO-T1 price control settlement.** Acting in accordance with its statutory duties (§2 above), Ofgem effected in the case of the three TOs, the RIIO-T1 arrangements as a price control settlement for the 8 year period 2013-2021. The RIIO-T1 price control settlement allows each TO to receive remuneration based on allowed expenditure and other activities in accordance with the terms of their statutorily-modifiable TL (s.11A), calculated by reference to a carefully designed and transparent formula set out in the RIIO-T1 instruments.

4. **RIIO-T1 and consultative due process.** The RIIO-T1 price control settlement and the arrangements associated with it were arrived at following a transparent consultative and industry-wide due process. For the post-31 March

2021 period there will be a similar price control settlement (RIIO-T2), attracting similar consultative due process standards. Those standards are legal and regulatory standards which are well known and understood, and Ofgem has a published consultation policy. Together with regulatory requirements such as certainty and proportionality, are necessary for the public law legitimacy of arrangements introduced by Ofgem.

5. **OFTO data informing price controls.** As KMPG pointed out in a July 2015 report for SHE Tranmission (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 levels and efficiency assumptions when it sets prices for onshore electricity transmission every eight years'.*"

6. **Financial parameters of the price control settlement.** The RIIO-T1 settlement includes clear and established *financial parameters*, built into the RIIO-T1 instruments and found within the TLs themselves. For present purposes it is sufficient to identify by way of illustration.

   6.1 **Asset Life.** Financial parameters regarding asset life establish a formula for the relevant period of years across which allowed expenditure on new assets is to be spread and so how it is to be capitalised and depreciated within the allowable revenue.

   6.2 **Cost of Capital.** Financial parameters regarding cost of capital establish a formula for establishing the allowable annual percentage of the asset value to be recovered during the 8-years of the control, one element of which (corporate debt) is annually varied on an index-linked basis (SpLC6D.20).

   6.3 **Totex Incentive Mechanism (TIM).** Financial parameters which incentivise actual total expenditure are known as TIM (Totex Incentive Mechanism) (SpLC6C.4) and involve a risk/reward-sharing percentage between the TO and consumers, adjustable as specified.

7. **The RIIO-T1 SWW mechanism for large new projects.** Acting in accordance with its statutory duties (§2 above), Ofgem included in the RIIO-T1 price control settlement a carefully designed mechanism to permit the amendment of allowed expenditure referable to the outputs of strategic wider works (SWW) (SpLC6I). This SWW uncertainty mechanism involves the identification of a new large transmission project for construction, operation and maintenance, for

which the TO will be responsible in accordance with its own licence and statutory duties (§1 above). SWW is a mechanism whose terms are the subject of published instruments, arrived at after a transparent, and industry-wide consultative due process (§4 above).

8. **Applying the SWW mechanism.** In approving allowed expenditure under the SWW mechanism Ofgem acts as best calculated to further the protection of existing and future consumers, wherever appropriate promoting effective competition between those commercially concerned with electricity transmission, supply or distribution (§2 above). Ofgem will address the needs case and project assessment for the new project, and scrutinise the nature of the arrangements and the efficiency of their costs. Ofgem will *"estimate the efficient cost of constructing and operating new projects"* and *"can draw on independent expertise and benchmarks from other projects"* (ITPR Final Conclusions 17.3.15 §3.10). A good working example of the SWW mechanism in action is the November 2013 decision for the Kintyre-Hunterston project.

9. **SWW takes account of licensee-procurement.** One feature designed into the project assessment for the SWW mechanism under the RIIO-T1 price control settlement is that *"relevant information"* from the licensee TO to Ofgem includes *"evidence of efficient costs including information on … the licensee's supplier procurement and tender procedures"* (SpLC6I.38(c)). That supplier procurement will include statutory competitive procurement processes undertaken by the TO licensee, in accordance with its statutory duties, to identify corporate entities available as principal contractors pursuant to framework agreements. It may also include competitive processes where principal contractors bid for projects. And it may include additional competitive procurement processes for specific elements of projects (eg. construction), undertaken by a principal contractor to identify cost-effective sub-contractors.

10. **SWW and protecting consumer interests.** In designing the SWW mechanism within the RIIO-T1 price control settlement, Ofgem needed to be – and was – satisfied that SWW output adjustment was a regulated approach to large new projects (having regard to licensee-procurement: §9 above) which protected the interests of existing and future consumers and promoted appropriate competition to the extent appropriate (§2 above). Ofgem also needed to be – and was – satisfied that the SWW mechanism was 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 (§1 above). As Government explained in a January 2016

Impact Assessment (p.4), the SWW mechanism operates by *"ensuring that investments are in the interest of existing and future consumers"*. As Ofgem put it in its Final Proposals for SPT and SHE Transmission (Supporting Document 23 April 2012 p.58): *"The SWW arrangements are designed to ensure value for money for consumers"*.

11. **SWW and not reopening financial parameters.** An established principle in the design of the SWW mechanism is that the revenue adjustment, based on projected expenditure for the new project which meets the needs case and project-assessment criteria, will be granted through the application of the financial parameters of the relevant price control settlement (§6 above). Those financial parameters cannot under SWW themselves be reopened. That means the adjustment for projected expenditure becomes an allowable revenue by adopting parameters such as the asset life formula, the cost of capital formula, and the TIM. So, for example, as Ofgem explained in its Final Proposals for SPT and SHE Transmission (Supporting Document 23 April 2012 p.58 §1.5): *"The same financial parameters for their overall price control package (set out in Chapter 5) will apply to projects approved under SWW during RIIO-T1"*. Accordingly, the financial parameters are not reopened when SWW allowed expenditure adjustments are *"applied through the Annual Iteration Process"* (ET1 Price Control Financial Handbook (February 2013) at §8.6).

12. **RIIO-T1 price controls are a *"competition proxy"*.** Price controls set under the RIIO-T1 settlement, including its SWW output adjustment mechanism, are all part of a regulated system which stands as 'a proxy for competition'. As the Secretary of State for Energy & Climate Change wrote to the Chair of the Energy and Climate Change Committee (21 January 2016): *"price controls … serve as proxies for direct competition"*. As the Department's Explanatory Notes to the January 2016 Draft Legislation on Energy put it (p.18): *"Price controls limit the amount of allowed revenue that a network company can take over the length of a price control period and serve as a proxy for competition"*.

13. **Mid-Period Review.** Another feature designed into the RIIO-T1 price settlement (§3 above) is a carefully circumscribed mechanism for four year (mid-period) review of certain components of the price control. That review mechanism does not allow the financial parameters (§6 above) to be reopened: see MPR Consultation November 2015 §1.23. It does not allow the rewriting of the SWW mechanism so as to allow those parameters to be reopened. It does not allow for a new and alternative methodology to SWW to be introduced into or alongside the RIIO-T1 price control. The mid-period review under RIIO-T1

culminated in a final decision in February 2017 and Ofgem identified no relevant change, nor any relevant problem, regarding the RIIO-T1 settlement or SWW mechanism.

2010-2016: The CATO Proposal for Competition with TOs

14. **The CATO Competition Proposal.** During the six years between 2010 and 2016 Ofgem and Government identified the possibility of introducing competition involving third party market entrants for an Ofgem-regulated TL and associated revenue stream for the delivery (constructing, operating and maintaining) of a new transmission project. This would be achieved, where appropriate and justified, by an Ofgem-run competition with competitive tendering to determine which commercial entity would secure a new TL for the new part of the transmission system, with a revenue allocated through the terms of the new TL, and the successful tenderer having the responsibilities and statutory duties of a licensee (§1 above). The essence of this competition was that Ofgem's "*regulatory toolkit*" would include the option to "*give licensed third parties the revenue rights and obligations associated with the delivery or large and separable network projects and ownership of associated assets*" (RIIO: A New Way to Regulate Final Decision October 2010 §6.20), where "*we would be responsible for designing and running the selection process*" (§6.24). So, as Ofgem explained: "*We will run competitive tenders to identify parties to construct, own and operate*" new onshore transmission assets (Impact Assessment 27 May 2016 §1.1). CATO was described as a competition-for-transmission alternative which could in principle (RIIO-T1 Final Proposals 23 April 2012 §1.34) be used for large projects otherwise addressed under the SWW mechanism (§7 above). It reflected a recognised model of licensing, for which Parliament statutorily empowered in the case of offshore transmission of OFTOs (EA 89 s.6C). The onshore equivalent for competition with TOs was the proposal for CATOs (competitively appointed transmission owners).

15. **The CATO Proposal and consultative due process.** Various steps were taken by Ofgem and Government to pursue an industry-wide consultation, engagement and impact assessment in relation to the proposed competition model of CATOs. There were consultation papers, industry working groups, a Parliamentary committee report, with further consultation and scrutiny necessary before any arrangements were identified. As Government told the Energy and Climate Change Committee (Response 19 July 2016 §19): "*Ofgem will continue to consult broadly on the introduction of competition in advance of the*

introduction of any secondary legislation, and intends to lay out in more detail how projects will be tendered and energised in a timely way".

16. **The CATO Proposal and the recognised non-statutory alternative of SWW.** It was necessary throughout the impact assessment analysis for the CATO Proposal for Government, with Ofgem, to address what alternative to proposed legislation came closest to achieving the same regulatory objectives. Throughout the process 2010-2016, in addressing the proposal for statutorily-underpinned CATO competition, it was recognised that the alternative (or 'counterfactual') to the legislative CATO proposal was the price control settlement under RIIO-T1, with its SWW output adjustment mechanism. There was no other alternative policy option which could be envisaged: see eg. DECC Impact Assessment 21 January 2016 §§22-23.

17. **The CATO proposal: actual competition.** The basis of the CATO competition proposal was clear. It involved "*extending competition*" by reference to Ofgem's statutory duty of, wherever appropriate, promoting effective competition (EA 89 s.3A(1B) (Impact Assessment 27 May 2016 §1.6). It meant actual competition, intended in particular to bring: (1) new entrants and innovation; and (2) the revealing of the real-world, true costs arising where there was a real-world, true competition. This was the described virtue of actual "*competitive pressure*" to "*remove barriers to entry and reveal appropriate costs*" (Impact Assessment 27 May 2016 §1.6). It involved actual, real-world competition, on the basis that "*to estimate the efficient cost or constructing and operating new projects*" based on "*independent expertise and benchmarks from other project*" meant "*we do not know the true costs*" (Ofgem Final Conclusions 17 March 2015 §3.10).

18. **The CATO proposal: the need for legislation.** Government and Ofgem were clear that primary and secondary legislation were necessary if competition for onshore transmission were to be introduced. It is not difficult to see why. Express statutory provisions had been needed to empower OFTO competitive-tendering for offshore transmission (s.6C) and the primary legislation secured that a competing third party, successful in becoming a licensee in respect of the offshore transmission assets, would have the statutory duties of a licensee (§1 above: EA 89 s.9(2)).

19. **The CATO proposal: the need for very clear frameworks.** Foremost in the thinking in relation to proposed competition was the need for a very clear set of frameworks. When Ofgem was asked by the Energy and Climate Change Committee about lessons from the OFTO regime, the Committee was told by

Ofgem's competitive networks witness (Mr Beel, oral evidence 22 March 2016 Q116) that the first of the *"lessons to be learned"* related to *"having a very clear framework within which we run the tendering process. That includes the legislative framework, the regulatory framework, the commercial framework and how we run tender processes. It is about making sure it is clear for investors and it is consistent so that investors can get confidence from what is being put before them that they can invest into that regime"*.

20. **The CATO proposal: key consumer/public interest functions.** Among the important features of the proposed competition in respect of new large projects was that Ofgem would have important functions, to be approached in accordance with the wider public and consumer interest, to determine questions engaging wider consumer and public interest, in the case of any particular project at a particular time. That would include the consideration of all relevant *"factors"* when making any decision as to whether to run a competitive tender (see eg. Ofgem Decision 25 November 2016 p.6), and in making any subsequent decision evaluating bids on their merits (see eg. Ofgem's slides p.11 for the 7 December 2015 Stakeholder Event). These important decision-making functions, and the need to avoid the risk of arbitrariness through a legal and regulatory vacuum, illustrate the need for further and full consultation, impact-assessment, evaluation and public scrutiny in the design of the primary and secondary legislation and other associated instruments and documents.

2017: The CATO Proposal is Paused

21. **Pausing the CATO programme.** After 6 years of pursuing the possibility of a properly designed and underpinned competition model for new large transmission projects, Ofgem informed an Industry Group Meeting in March 2017 that: *"If legislation is not forthcoming, or if there is no clarity on legislation, Ofgem will pause the CATO programme until legislation is more certain"* (Minutes 16 March 2017 §2.1). No legislation or clarity was forthcoming and the CATO proposal was and remains paused.

22. **Thinking about other ways to introduce competition.** When Ofgem acknowledged the pause in the CATO proposal, it said it wished to consider *"other approaches for introducing competition in transmission"* (Minutes 16 March 2017 §2.1). In an update to stakeholders in June 2017, Ofgem repeated that it was thinking about alternatives *"for introducing competition"* (Update 27 June 2017 p.2). That was a clear retention of the objective of introducing real

competition (§17 above). So too, Ofgem's HSB Consultation Paper (30 August 2017) spoke of *"Introducing competition"* (p.12), *"benefits from competition"* (p.13) and *"the benefits to consumers from introducing competition"* (§1.15).

23. **Ensuring alignment with work on RIIO-T2.** In updating the industry in June 2017, in the light of the pause in CATO programme, Ofgem explained that it would align any new and alternative competition proposals with its thinking in relation to the next price control period (RIIO-T2). It said it intended to "*align development of longer-term arrangements for introducing competition into onshore electricity transmission with our broader work on development of regulatory arrangements for the RIIO-2 period*" (Update 27 June 2017 p.2). The first RIIO-2 open letter consultation was published around the same time in July 2017 and said: "In RIIO-2, we will consider whether the scope of competition should be expanded to include the majority of new, high value and separable projects in the onshore sector, and how third parties can bring in new ideas to solve network system problems."

The HSB Project: Potential New 'Delivery Models'

24. **New models in the HSB consultation.** In August 2017 Ofgem produced a project-specific consultation paper in respect of NGET's project at Hinkley-Seabank (HSB). There, Ofgem said it was considering for HSB *"potential delivery models"* which included *"a special purpose vehicle model"* (SPV model) and *"a model intended to provide a proxy for the benefits of competition"* (CPM). In January 2018 Ofgem proceeded to consult on a 'minded-to' decision favouring one of the models (CPM) for HSB. At the heart of the supposed justification for the CPM is a case referable to savings achievable by disapplying established financial parameters (§6 above) of the price control (eg. cost of capital). It was in August 2017 that Ofgem spoke for the first time of *"introducing or replicating the outcomes of competition"* (HSB Consultation Paper 30 August 2018 p.6). That was a reference to the idea of CPM in the case of large new projects which involved no actual competition at all (cf. §§17, 22 above). It was actually a suggested new way of estimating efficient cost of financing the construction and operation of new projects, drawing on independent expertise and benchmarks. But that of course is what the established SWW mechanism already did (§8 above), in the interests of consumer protection (§10 above), with its principled and deliberate design (§§9, 11), as part of a price control settlement which is itself a competition proxy (§12 above).

25. **New Models and HSB: SSE's consultative due process warning.** SSE pointed out to Ofgem in October 2017 that there has been no transparent, consultative and industry-wide due process (§§4, 15 above) in relation to these new models, and no Regulatory Impact Assessment produced. SSE's Head of Regulation-Transmission wrote to Ofgem's Head of Transmission Competition Policy (letter dated 12 October 2017 p.2) pointing out that "*[b]y incorporating the proposals for competition within the consultation for a specific project Ofgem understates the significance of competition for all stakeholders*" and calling on Ofgem to ensure that "*the proposed extension of competition is approached in a more appropriate way, with a stand-alone engagement with all affected stakeholders, including consultation and a full Regulatory Impact Assessment*". Unfortunately, Ofgem decided to press ahead to a 'minded-to decision' and consultation on HSB adopting the CPM model, accompanied by a CEPA report (focused on re-opening the cost of capital formula under the financial parameters (§6 above) of the price control settlement for HSB). At the same time Ofgem issued to the industry an 'update' document describing the two models and issuing a generic, unfocused and un-timetabled invitation to comment.

Ofgem's Suggested 'Competition Proxy Model' (CPM)

26. **About the CPM.** The essence of CPM is apparently as follows. Ofgem takes a project which would otherwise meet the criteria for SWW adjustment under the RIIO-T1 price control mechanism. It adopts an approach which culminates in a revenue adjustment for insertion into the incumbent TO's TL. The TO has the important licensing and statutory obligations (§1 above). To get to the revenue adjustment Ofgem disapplies the SWW mechanism (§§7-10 above) and reopens (cf. §11 above) the financial parameters of the relevant price control (§6 above). Ofgem is unable, because it lacks the statutory powers, to hold a real world, true competition between third parties. Instead, Ofgem attempts to forecast what it thinks the position would have been had there been such a competition, using as benchmarks the data which it takes from the experience with OFTOs. Having done this, it arrives at a new adjusted price control with a new cost of capital, new asset life, new TIM, new duration, and so on.

27. **Problems of principle with the CPM.** The problems of principle with this approach are immediately encountered. Ofgem's proposed CPM suffers from clear and fundamental defects of principle. This can be illustrated as follows:

28. **CPM fails the actual-competition objective.** The stated objective, throughout the 2010-2016 proposal of CATO competition with incumbent licensee TOs in

respect of new transmission projects, involved introducing actual competition (§17 above). That objective was retained when the CATO proposal was stalled for lack of legal power to implement it (§22 above). The promotion of competition is a distinct feature of the primary legislation and the regulator's duties (§2 above). But the first problem is that CPM does not involve actual competition. It is a pretend competition. Under CPM, there is no competition run by Ofgem (or anyone else). There are not the identified virtues of a competition: there is no new entrant; and there is no real-world actual cost information revealed from such a competition. CPM is what it says: 'competition proxy'. But 'competition proxy' is the nature of what price control regulation is (§12 above). So, a proposed introduction of CPM brings into sharp focus this question. Can it be legitimate for Ofgem to introduce, in place of the established method for 'competition proxy' RIIO-T1 price controls with its SWW mechanism for new projects, a new and different 'competition proxy' approach to price controls with a different name and different parameters?

29. **CPM breaches the clear parameters of settled price control.** An established feature of the SWW mechanism (§11 above) within the 'competition proxy' exercise of price control (§12 above), a mechanism recognised as protecting consumer interests (§10 above), is that arriving at the TO's adjusted allowed expenditure can carry with it no reopening of the financial parameters (§6 above) of the relevant price control. So, Ofgem could not – in the name of its statutory duties (§2 above) – decide to arrive at a SWW price control adjustment for a TO's large new transmission project by reopening (§11 above) parameters for cost of capital, asset life value or TIM (§6 above). Nor could it do so in the context of the Mid-Period Review (§13 above). It is no answer for Ofgem to say that the outcome price control could be lower if it did reopen cost of capital, or asset life value, or TIM. That is exactly the approach which is not open to it, under the carefully designed price control settlement. Yet that is precisely what, under the label of 'competition proxy', Ofgem now threatens to do, relying on a CEPA report whose focus is on estimating the cost of capital for a single project. Calling the model an alternative to SWW, in the name of a 'competition' which is no more real than it ever is under SWW (hence, 'proxy'), is a difference of label. The fact that it was not open to Ofgem to rewrite or disapply the price control settlement in this way is no doubt why nothing approaching what is now called CPM featured as an alternative to the CATO legislative response in the CATO impact assessments. The CPM by its nature frustrates the design, purpose and certainty of the price control settlement. By no standard of scrutiny will that be upheld.

30. **CPM and breach of basic procedural standards.** In a regulatory environment where standards of consultative due process are well understood (§§4, 15 above), and where Ofgem spent some 6 years consulting and engaging with stakeholders in the context of the CATO proposal (§15 above), the process now adopted in relation to CPM is plainly wholly deficient. After the CATO pause in March 2017 (§22 above), Ofgem conspicuously failed to engage in any consultation regarding the introduction of CPM (or SPV model) alongside SWW under RIIO-T1. It could have done so in June 2017 (§23 above), or in August 2017 (§24 above). It could have issued a comprehensive regulatory impact assessment, as is statutorily required for a significant change, and as had taken place in relation to the CATO competition proposal. Ofgem has continued to ignore due process warnings (§26 above) and has, to the present day, still not undertaken any consultation or adequate regulatory impact assessment exploring the suggested case for CPM (or SPV model), which moreover has not been developed into a clear and crystallised set of proposed alternative arrangements. Even if there were not the serious substantive flaws, the introduction of CPM on the back of a project-specific HSB consultation is patently inadequate.

31. **CPM lacks coherence and clarity.** Ofgem is threatening to introduce CPM, as an approach to large projects who would otherwise be assessed for price control adjustment under SWW, without being in a position to provide the clear legislative, regulatory or commercial framework required in this area of regulation (§20 above). The posited competition which Ofgem purports to 'replicate' is utterly artificial: it is a fiction, and a legal impossibility. Nothing in the CPM 'replicates' whether the fictional and legally impossible competition would even happen in terms of the consumer interest (§20 above); nor does it address the question of whether the incumbent TO would choose to undertake risks inherent in the supposed lowest bid, or even whether it would win the supposed (but fictional and unlawful) competition. The CPM is also illogical in positing real-world revealed true cost information from an actual competition (§17 above), where that is what is and remains absent. It is a model which gives primacy (cf. §5 above) to benchmark information from the distinct regulated sector of OFTOs, which overstates their reliability and relevance and introduces arbitrariness and risk. It disturbs the careful balance and design of the RIIO-T1 price control. It clashes with Ofgem's own current thinking in relation to RIIO-T2, has a timing which is disjointed and dysfunctional viewed against the backcloth of the RIIO-T2 decisions of principle and policy; all of which in a context where Ofgem had stated that there would be alignment (§23 above). It is a classically disproportionate response, which cannot satisfy tests of

legitimacy and suitability. It does not even purport to identify what in concrete terms is supposedly wrong with the design and application of the SWW mechanism which Ofgem so carefully designed and adopted, and which it acknowledges remains *"viable"* (HSB Consultation Paper 30 August 2017 §3.13).

Ofgem's Suggested 'SPV model'

32. **The proposed SPV model.** The essence of the SPV model appears to be as follows. Ofgem starts with a project which would otherwise meet the criteria for SWW adjustment under the RIIO-T1 price control mechanism. It adopts a process which ends with a revenue adjustment for insertion into the incumbent TO's TL, referable to the new project. But, as with the CPM, it disapplies the SWW mechanism and it disapplies the financial parameters of the relevant price control (§6 above). Ofgem lacks the legal powers to conduct a competition by which a third party can compete to be the licensed entity with the legal (licence and statutory) responsibilities of delivery, operation and maintenance of the transmission assets (§18 above). Unable to proceed with an Ofgem-run competition to be a TO licensee, Ofgem purports instead to mandate a competition by the incumbent TO licensee. Under this mandated competition, the TO licensee is purportedly to be required to act as a 'front' for what is in substance intended by Ofgem to take effect like a CATO. The TO licensee is to be the regulated 'front', retaining the licensing and statutory duties for new transmission assets. Behind it, Ofgem intends there to be a distinct company (SPV), selected following a competitive tendering process run by the TO following direction from Ofgem. The SPV is supposed to undertake construction, operation and maintenance but with no licence, no price control, and no statutory responsibilities. It is supposed to receive, through the conduit of the licensee TO, a price control allocated to the TO through the terms of the TL. That price control to and in the TL or the TO involves reopened financial parameters: cost of capital, asset life, TIM etc. (§6 above).

33. **Problems of principle with the SPV model.** Focusing again on headline points of principle, Ofgem's SPV model also suffers from obvious and fundamental defects, illustrated by the following.

34. **Impermissible in principle as a competition by a TO.** Ofgem has no power to mandate a licensee TO with a proposed new transmission project to enter into a competition to identify a company with whom to contract, or the terms of payment under that contract, still less to do so as a 'fronting' competition. This is not a situation like the Shetland distribution case (Ofgem's HSB Consultation

30 August 2017 §1.11), where a specific licence provision agreed during the relevant price control process empowered Ofgem to mandate a process to achieve a systems operator's statutory duty regarding security of supply. If Ofgem did have such powers it would be able to point to their statutory and regulatory underpinning, Ofgem's SWW function would do more than take account of licensee-procurement (§9 above), and the counterfactual for CATO impact assessment (§16 above) would have been very different. Alongside its own procurement obligations, the incumbent TO has a competition-promotion duty in the Electricity Act 1989, specifically conferred by Parliament, but it is limited to facilitating competition in generation and supply (§1 above), not competition in transmission.

35. **Impermissible in principle as a competition to be the transmission deliverer.** If the SPV model is seen as a competition by third parties in respect of the delivery of the new transmission project, there are further fundamental flaws. Delivery of a transmission project is a statutorily recognised function which carries the legal consequences of responsibility, under the licence and by statutory duty (§1 above). It cuts across the statutory scheme to regard an entity as in substance delivering on the operation of a transmission asset, when that entity gets neither the licence responsibility nor the statutory responsibility. The statute sets its face against 'fronting' arrangements, and the purpose of the statutory scheme is frustrated by them. Such a competition is no more and no less than an attempt by Ofgem to achieve through an impermissible back-door the outcome which was recognised in the context of CATOs as not achievable through the front-door, in the absence of amendment to the primary legislation. If Ofgem had powers of this kind, it would not have needed the OFTO licensing regime (§14 above); it could simply have imposed competition 'fronting' arrangements.

36. **Impermissible as a price control allocated to the TO.** In law, what Ofgem is proposing through the SPV model is and remains a revenue allowance in respect of a new project. That is the TO's price control, under the TO's licence, in the RIIO-T1 price control period. Ofgem has no power to introduce a different measure of price control, by giving the approach a new label (here, SPV model) and allowing to the TO a revenue which reopens the parameters of the price control which are impervious to change under SWW (§11 above) or Mid-Period Review (§13 above). As with the CPM, this breached the clear parameters of the price control. Here again, the fact that it was not open to Ofgem to rewrite or disapply the price control settlement in this way is why nothing approaching what is now called SPV model featured as an alternative

to the CATO legislative response in the CATO impact assessments. Like the CPM, the SPV model by its nature frustrates the design, purpose and certainty of the price control settlement and could not withstand scrutiny.

37. **SPV model and TTT.** Ofgem's project-specific consultation on HSB refers several times to Thames Tideway Tunnel (TTT) as a reference-point for its SPV model. The comparison is illuminating. Ofwat, with its statutory duty to protect consumers wherever appropriate by promoting effective competition, already regulated incumbent appointed undertakers through price control mechanisms and allowed capital expenditure. The appointed undertakers, with their own statutory duties to develop and maintain efficient and economical systems of water supply, already often used competitive-tendering in delivering new infrastructure projects. For TTT, Ofwat was able to require the undertaker to hold a competitive tendering process, prohibiting it from doing the building and operation itself. What was envisaged was an SPV having contractual arrangements between it and the incumbent undertaker. But new primary legislation (in 2010) and new secondary legislation (in 2013) was needed, together with an array of consultative due process steps. Moreover, the legislation expressly addressed features like the successful tenderer being a licenseable infrastructure provider owing duties. Nobody thought the situation could be addressed, nor the statutory threshold (applicable only to new large projects threatening the undertaker's ability to provide services to customers) could be sidestepped, by using an alternative model and conduit through price controls.

38. **SPV model and breach of basic procedural standards.** As with CPM (§30 above), there is a clear breach of standards of consultative due process. Ofgem has, again, conspicuously failed to engage in any consultation regarding the introduction of SPV model, alongside SWW under RIIO-T1. It has issued no consultation of the sector in relation to the principle and has issued no adequate regulatory impact assessment, as is statutorily required for such a change. Ofgem continues to ignore the due process warnings (§26 above) as it explores the suggested case for SPV model, which has also not been developed into a clear and crystallised set of proposed alternative arrangements, including in spelling out how important consumer/public interest functions (§20 above) would be addressed. Even if there were not the serious substantive flaws, the introduction of SPV model on the back of a project-specific HSB consultation is wholly inadequate, and the absence of an adequate regulatory impact assessment is a clear breach of a procedural statutory duty.

39. **SPV model lacks coherence and clarity.** Ofgem is again threatening to introduce a model (SPV model) as an approach to large projects who would otherwise be assessed for price control adjustment under SWW, without being in a position to provide the clear legislative, regulatory or commercial framework required in this area of regulation (§20 above). The posited competition which Ofgem purports to impose is utterly artificial: it is a 'front', in which there is a mismatch between legal function and responsibility and the remunerated entity with a contractual arrangement. The SPV model disturbs the careful balance and design of the RIIO-T1 price control. It too clashes with Ofgem's own current thinking in relation to RIIO-T2, has a timing which is disjointed and dysfunctional viewed against the backcloth of the RIIO-T2 decisions of principle and policy; all of which in a context where Ofgem had stated that there would be alignment (§23 above). It too is a classically disproportionate response, which cannot satisfy tests of legitimacy and suitability. It too does not even purport to identify what in concrete terms is supposedly wrong with the design and application of the SWW mechanism which Ofgem so carefully designed and adopted.

Conclusion

40. **Consequences for CPM and SPV model.** Even leaving aside problems of merits and merits review, CPM and SPV model are each a regulatory response which it would be unlawful – viewed against applicable legal standards of lawfulness, reasonableness, fairness and proportionality – for Ofgem to adopt. Any decision to adopt it as a proper and available regulatory response in principle would attract successful judicial review, and any decision to adopt it for any project would attract a successful appeal to the CMA. Ofgem should concentrate on operating the SWW regime according to its settled terms, and on the appropriate design of the RIIO-T2 price control.

41. **What went wrong.** It is perhaps not difficult to see what has happened. After 6 years of conscientious work on a proposal for CATO competition, with a necessary statutory underpinning and a great deal of consultative due process and scrutiny as to its design and implementation, Ofgem was faced with a pause in the legislative process. It was not responsible for that pause, but it has been responsible for the ad hoc sketching out of alternatives which, had they been sound, would have featured throughout in the analysis of alternatives. Ofgem has come up, in the name of 'competition', with two undeveloped and unconsulted-upon models, each raised in a project specific context of HSB. Each is artificial. One is a proxy based on a fictional competition, which clashes

with the design of the well-established proxy (§12 above). It has come up with a competition which fails whether it seen as competition by, or a competition with, an incumbent TO, which is intrusive regulation without power, which cedes function without securing responsibility. Neither squares with Ofgem's own, present or future, price control arrangements. Ultimately, each model sets a TO's price control in a way which flies in the face of established methodologies, and for no legitimate or cogent reason.

42. **A practical test.** It is not difficult to test the legitimacy of all of this. Suppose Ofgem were applying the appropriate mechanism under the price control settlement for new projects (SWW). Suppose Ofgem, in its recognised role of receiving information to take account of licensee-procurement (§9 above), sought to insist that the licensee TO should enter into a back-to-back competitively-tendered arrangement with an independent company making payments under a delivery agreement, so that Ofgem could set the licensee's adjusted allowed expenditure by reopening the financial parameters (§6 above) of cost of capital, asset life or TIM. Or suppose Ofgem, in its recognised role of evaluating the SWW adjusted allowed expenditure based on a project assessment as to efficiently incurred costs, were to announce that it had decided to reopen those financial parameters of cost of capital, asset life or TIM. Or suppose Ofgem, at the mid-period review, announced that it was going to redesign the SWW mechanism so that those financial parameters could be reopened. All of this is precisely what Ofgem is not permitted to do. To repackage the same outcome by giving it a different label, and treating it as though it were a competition option (with no statutory or regulatory underpinning), is obviously wrong in principle. Ofgem should drop these unconvincing and flawed suggestions.

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For SHE Transmission