



Making a positive difference
for energy consumers

To all interested stakeholders

Email: NTIMailbox@ofgem.gov.uk
Date: 14th September 2018

Dear Colleagues,

Update on Extending Competition in Transmission

This letter updates stakeholders on our arrangements to extend competition in onshore electricity transmission. It sets out the context for the work we have done to date and an overview of the documents we have published today on the Special Purpose Vehicle (SPV) model and the Competition Proxy model (CPM). This document also provides a forward view on our wider programme of competition in onshore electricity transmission networks and expected next steps, including how we propose to treat future projects that meet the criteria for competition.

Context

In June 2017 we published an update on our plans to extend competition in onshore electricity transmission, stating that we are deferring further development of the Competitively Appointed Transmission Owner (CATO) regime until the timing of the necessary legislation is more certain. In this context, through 2017 we considered alternative ways in which we could protect the interests of existing and future consumers by implementing competition, or seeking to replicate its effects.

In August 2017 we published our Hinkley-Seabank (HSB) consultation, which set out our views for consultation on:

- The needs case for the HSB project;
- Two alternative delivery models that would benefit consumers and that we considered could be implemented for HSB and future projects, namely, the SPV model and CPM; and
- The appropriateness of using our existing criteria for competition for the SPV model and CPM.

Our most recent update in January 2018

In our January 2018 "Update on competition in onshore electricity transmission" (January 2018 Update), we set out:

- Our updated position on the overarching form and core features of the SPV model and CPM in general, taking into account the stakeholder responses received in relation to our August 2017 consultation;
- Our decision to apply our existing criteria for competition to projects when making a decision whether to apply the SPV model or CPM;
- The end-to-end decision-making process we intend to use for future projects submitted to us through the Strategic Wider Works (SWW) licence mechanism.

We also published a minded-to consultation on the delivery model for the HSB project in January 2018.

HSB decision in July 2018

In July 2018 we published a document confirming our decision to implement CPM for the first time in the delivery of the HSB project. That document sets out our reasons for that decision and sets out detail on the 'cost of capital' methodological framework we will use to determine allowed financing costs for HSB. It also sets out regulatory arrangements that will apply to the HSB project.

Documents published today

Alongside this letter we have published a set of documents providing our view of the development and application of the CPM and the SPV model exclusively for future projects beyond HSB:

- A consultation on the commercial and regulatory framework for the SPV model;¹
- Update on the Competition Proxy delivery model;² and
- An Impact Assessment (IA) setting out our analysis of the benefits and costs to consumers of applying the SPV model and CPM to projects in general.

For the avoidance of doubt, the documents set out above do not reopen or reconsider any aspect of the decision on the delivery model for HSB. These documents relate only to our application of the CPM and SPV model to future projects.

Consultation on the commercial and regulatory framework for the SPV model

This consultation sets out our views on the next level of detailed design of the SPV model, building on our previous documents published in August 2017 and January 2018. The consultation contains our views and further detail on several key areas of the SPV model including:

- Our proposed commercial framework for the SPV model, supported by a report produced by our external consultants, Agilia;

¹ <https://www.ofgem.gov.uk/publications-and-updates/extending-competition-electricity-transmission-commercial-and-regulatory-framework-spv-model>

² <https://www.ofgem.gov.uk/publications-and-updates/update-competition-proxy-delivery-model>

- Our proposals for the regulatory framework to support and implement the SPV model within the TO licence, including illustrative proposed amendments to the TOs' licences for consultation; and
- Our initial view of the procurement principles that a TO must take into account when developing its SPV tender documentation and running the competitive tender to appoint the SPV.

Impact Assessment

We have published an Impact Assessment (IA) setting out our analysis of the benefits and costs to consumers of applying the SPV model and CPM to future projects that meet the criteria for competition, against a counterfactual of delivery through the prevailing price control by the relevant incumbent Transmission Owner (TO). The IA is based on the SPV model and CPM as set out in the publications described above. It considers the benefits and costs of these two models, considering the models' application in general to new, separable and high value projects rather than in the context of a specific project.

The IA shows that there are significant potential benefits to consumers from applying the SPV model or CPM under a range of different scenarios.

We invite stakeholders to provide responses to our SPV consultation and the IA as it pertains to the SPV model. The closing date for responses is 26th October 2018. We have considered consultation responses in relation to the CPM previously in the context of the minded-to consultation on the delivery model for the HSB project in January 2018.

Update on the Competition Proxy delivery model

We have published an update on how we will consider applying the CPM for future projects. In this update, we set out the CPM regulatory arrangements that would apply to future projects. We also confirm that we will use the cost of capital methodology for new assets, which we developed with CEPA, and published alongside the HSB decision, to set the cost of capital for future projects under CPM.

In addition, we explain the specific adjustments to these arrangements we may consider to reflect the project-specific construction conditions of future projects. We will consult on any such adjustment as part of any decision to implement the CPM for individual projects.

Future application of the CPM and SPV model

Overall approach

We have set out on our website the list of potential projects that meet the criteria for competition, as identified by the System Operator (SO) in its Network Options Assessment (NOA) in January 2018.³ As set out previously, during the RIIO-T1 period, we will only consider SWW projects against the criteria for competition. We will undertake further development of our policy for projects during the RIIO-T2 period in line with our development of the RIIO2 price control.

We confirmed in our January 2018 Update that **we intend to consider the Competition Proxy and SPV delivery models for all future SWW projects that are subject to a needs case assessment during RIIO-T1**. We will do so only where a project meets the criteria for competition, and we will consider the status quo SWW RIIO delivery arrangements alongside the Competition Proxy and SPV delivery models.

³ <https://www.ofgem.gov.uk/electricity/transmission-networks/critical-investments/strategic-wider-works>. More information on the status of those projects can be found on the relevant TO's websites.

We confirm our view⁴ that, for some projects the SPV model could (if implemented efficiently) have a larger benefit for consumers over CPM because of its potential to deliver additional savings for consumers. For example this would be through introducing innovation and additional players into the delivery of onshore electricity transmission leading to capital and operational cost savings, and to provide further benchmarks to inform our ongoing price control regulation via RIIO. In order to ensure the most economic and efficient outcome for consumers, we consider that **Transmission Owners should use reasonable endeavours to ensure projects that may meet the criteria for competition are brought forward for our consideration sufficiently early to allow efficient and timely implementation of the SPV model.**

In due course, if enabling legislation for the CATO regime is taken forward, we would also need to consider the merits of the CATO delivery model for a project that meets the criteria for competition.⁵ We remain committed to working with Government to seek an appropriate opportunity to introduce the legislative change necessary to implement the CATO regime, which we fully support and maintain will also offer a beneficial outcome for consumers over delivery under the counterfactual RIIO (SWW) mechanism.

Detailed process

In our January 2018 Update, we set out our indicative processes for applying the criteria for competition, and for deciding whether a project should be subject to competition. This included how these processes relate to the Initial Needs Case (INC) and Final Needs Case (FNC) stages we apply to eligible SWW projects.⁶

We have set out in Appendix 1 of this document a description of these processes. We expect to use these processes for applying the criteria for competition, and for deciding whether a project should be delivered through the SPV model or the CPM. The processes set out in Appendix 1 have not changed in substance from our January 2018 Update; however, we have made minor updates to wording in some places to reflect the updated terminology used in our other documents published today.

Next steps in our overall programme for extending competition in electricity transmission

As set out in the documents published today, we are continuing to develop various aspects of our arrangements for implementing competition in onshore electricity transmission.

We have set out in Figure 1 overleaf our current workplan across both the SPV model and the CPM. We have included indicative timetables for the SWW projects we are currently considering and that we currently expect to consider over the next year, although the timetables for those projects are indicative as they are dependent on the timely submission of high quality information by the relevant TO and are also dependent on whether we decide to approve or reject each needs case submission.

Changes to TO licence conditions

We are intending to begin making changes to the TO licences to implement the policies and outcomes of the CPM and SPV model. We are currently in the process of developing those changes. For the avoidance of doubt, we intend to develop both the CPM and SPV model licence modifications for implementation across all three TO licences.

⁴ As set out in the January HSB minded-to consultation.

⁵ We have not included our approach to assessing a project's suitability for CATO in this document.

⁶ <https://www.ofgem.gov.uk/publications-and-updates/guidance-strategic-wider-works-arrangements-electricity-transmission-price-control-riio-t1-0>

CPM licence conditions

Our expectation is that, following workshops with affected parties, we will carry out an initial informal consultation on draft modifications to the licences of all of the TOs by the end of November 2018. Subject to consideration of responses to that consultation, we expect to be in a position to carry out a statutory consultation for a minimum period of 28 days in December 2018 or January 2019. These timelines will be influenced by the level of engagement from the TOs in developing the conditions and the responses we receive to our informal consultation.

The Authority will consider the responses to the statutory consultation. If the Authority decides to proceed with the modifications, it will publish its decision and the modifications including specifying a date, not less than 56 days from the publication of the decision, from which the modifications will have effect.

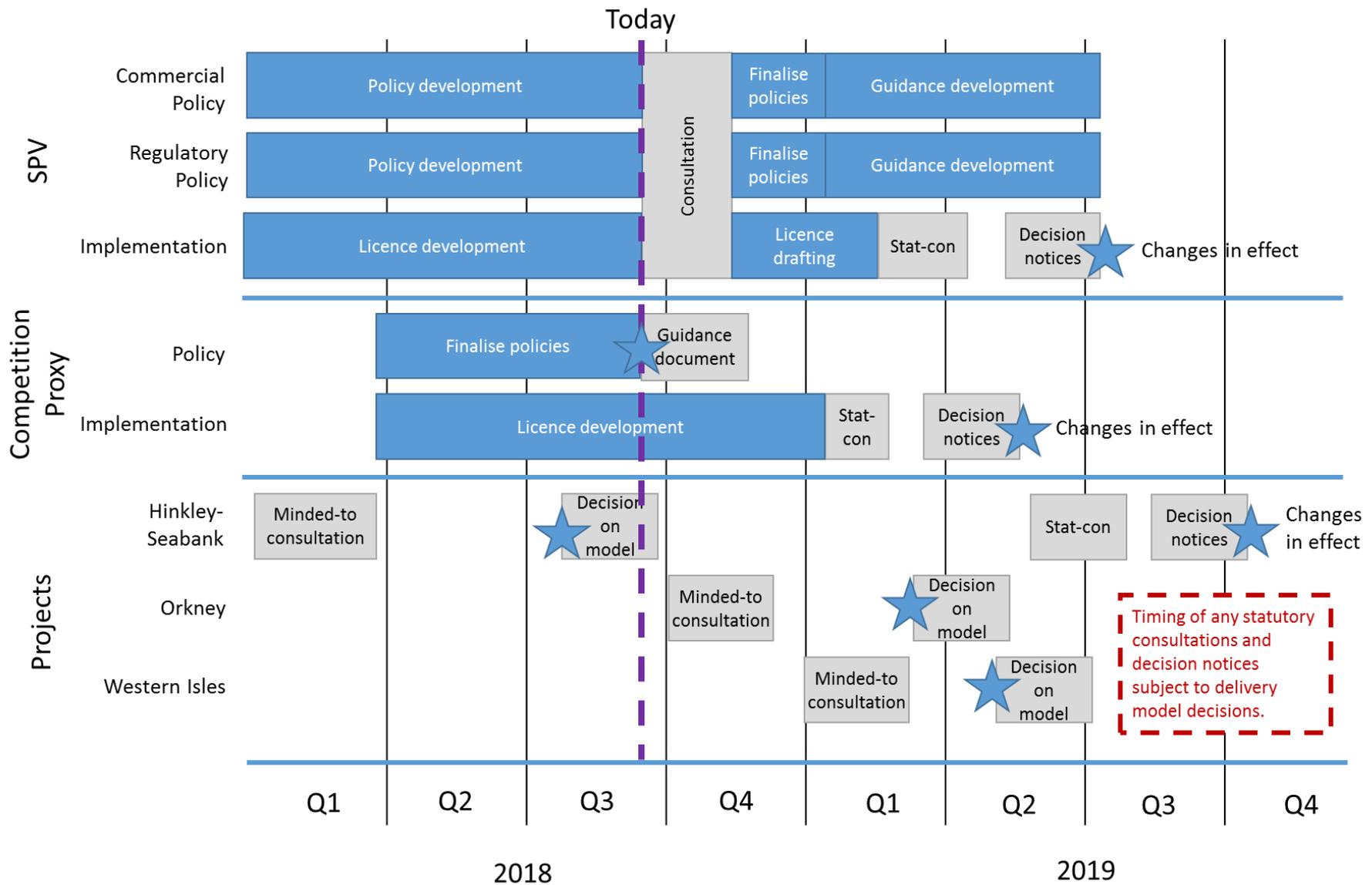
In due course we also intend to develop and consult on the specific licence modifications necessary for reflecting NGET's cost allowances for HSB under the CPM.

SPV model licence conditions

We have provided alongside our accompanying August 2018 SPV model consultation our indicative view of the structure and contents of the generic SPV licence condition for the implementation of the SPV model. As set out in that consultation, we intend to host a set of licence drafting workshops with stakeholders to discuss the proposed changes throughout Autumn 2018. We expect to undertake further development of the condition prior to those workshops in response to stakeholder views expressed in response to the consultation.

We anticipate a statutory consultation on the proposed changes in early 2019. We will update stakeholders further once the timetable is clearer following our Autumn workshops.

Figure 1



Links to RIIO2

In July 2018 we published our decision on the framework for the RIIO-2 price controls.⁷ We set out our decision to extend the role of competition (for the market) where it is appropriate and provides better value for consumers, including using the criteria for competition applied in ET (new, separable and high value) to identify projects suitable for competition in other sectors.

We set out a number of areas we will be considering of part of our development, including the processes for identifying and determining whether specific projects are suitable for late model competition.

We expect to consult more fully on the particular forms of competition for each network sector as part of the sector methodology consultations in 2018 and 2019.

Yours sincerely,

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⁷ https://www.ofgem.gov.uk/system/files/docs/2018/07/riio-2_july_decision_document_final_300718.pdf

Appendix 1 – End-to-end process diagrams

Process for decision-making

As described in the main document, we have set out in this Appendix the end-to-end process for integrating the application of the criteria and decisions on delivery models with the existing SWW mechanism.

This process distinguishes between our approach for future projects, where we anticipate that these projects will always submit an Initial Needs Case (INC), and our approach to projects without an INC stage. The latter relates to circumstances where it is more appropriate to progress a project straight to an FNC, such that it is not subject to our INC assessment under SWW.

Figures A1.1 and A1.2 set out the process under both the approaches described above for both the SPV model and CPM. We have included the process for projects delivered through SWW as a point of comparison.⁸

Approach for projects with an INC

Figure A1.1 sets out in a flowchart the end-to-end process for a project brought to us where that project will be subject to both an INC and a FNC stage assessment.

INC stage

At the INC stage we will, in summary, consider:

- Whether the project is likely to be needed (in line with relevant TO licence conditions and our SWW guidance);
- Whether the design of the project is suitably justified (in line with relevant TO licence conditions and our SWW guidance);
- Whether the project, in whole or in part, meets the criteria for competition;
- In considering the project against the criteria, whether to apply our principles for bundling, splitting, and re-packaging projects; and
- If the project (or a part of the project) meets the criteria for competition, which of the delivery models is the most appropriate to deliver the project (or part of the project).

Following a public consultation on our initial needs case assessment we will publish our initial views on the areas covered by our assessment. Alongside our views on the initial needs case assessment, we will also set out our views on our assessment of the project against the criteria for competition and the delivery model pathway the project will follow.

FNC and project costing stages

The FNC and project costing stages come after the INC stage. The process will be different for the SPV model and the CPM.

Under the SPV model we would expect the TO to develop early drafts of documentation and arrangements to support the future SPV tender (eg a draft proposed delivery agreement) before the FNC stage. At the FNC stage, we would confirm whether there is a

⁸ Full details of the process for projects delivered through SWW are available in the SWW Guidance, published on our website.

need for the project through our usual consultation and decision processes as set out in the relevant TO licence conditions and SWW guidance. We would also in parallel review the tender documentation and delivery agreement to support the future SPV tender. Following our decision on the FNC, the TO would run the SPV tender using the agreed documentation. Following the outcome of the SPV tender we would make changes to the TO's licence as appropriate to give effect to the project-specific arrangements set out in the delivery agreement.

Under the CPM, we would confirm whether there is a need for the project through our usual consultation and decision processes as set out in the relevant TO licence conditions and SWW guidance. After the consultation and confirmation of need at the FNC stage, the project will move into the project costing stage where we will assess the project costs and determine an indicative project-specific revenue stream. This will include our determination of the allowed cost of capital, in line with our cost of capital methodology for new assets. We would then make changes to the TO's licence as appropriate to give effect to the determined project-specific revenue.

Approach for projects without an INC

Figure A1.2 sets out the end-to-end process for projects without an INC, for example where a project has sufficiently advanced beyond the planning stage.

At the FNC stage we would confirm the need for the project and the suitability of the design of the project through our usual consultation and decision processes as set out in the relevant TO licence conditions and SWW guidance. We would also in parallel undertake an assessment of, and consult on:

- Whether the project, in whole or in part, meets the criteria for competition;
- In considering the project against the criteria, whether to apply our principles for bundling, splitting, and re-packaging projects;⁹ and
- If the project (or a part of the project) meets the criteria for competition, which of the delivery models is the most appropriate to deliver the project (or part of the project).

At the conclusion of the FNC stage, we will confirm our assessment of the project against the criteria for competition, and make a decision on the delivery model pathway the project will follow.

Under the CPM the project costing stage will be the same as the approach set out for those projects with an INC. This would culminate in us making changes to the TO's licence as appropriate to give effect to the determined project-specific revenue.

Under the SPV model, the TO will be required to undertake the activities it would have undertaken after an INC stage, ie activities to prepare for an SPV tender. Once those activities have been completed, the TO would run the SPV tender using the agreed documentation. Following the outcome of the tender we would make changes to the TO's licence as appropriate to give effect to the project-specific arrangements set out in the delivery agreement.

⁹ As we have made no changes to the criteria for competition, we consider that our principles for bundling, splitting, and re-packaging projects, as previously consulted on and confirmed in our November 2016 consultation, remain appropriate.

Figure A1.1 Approach for projects with an INC

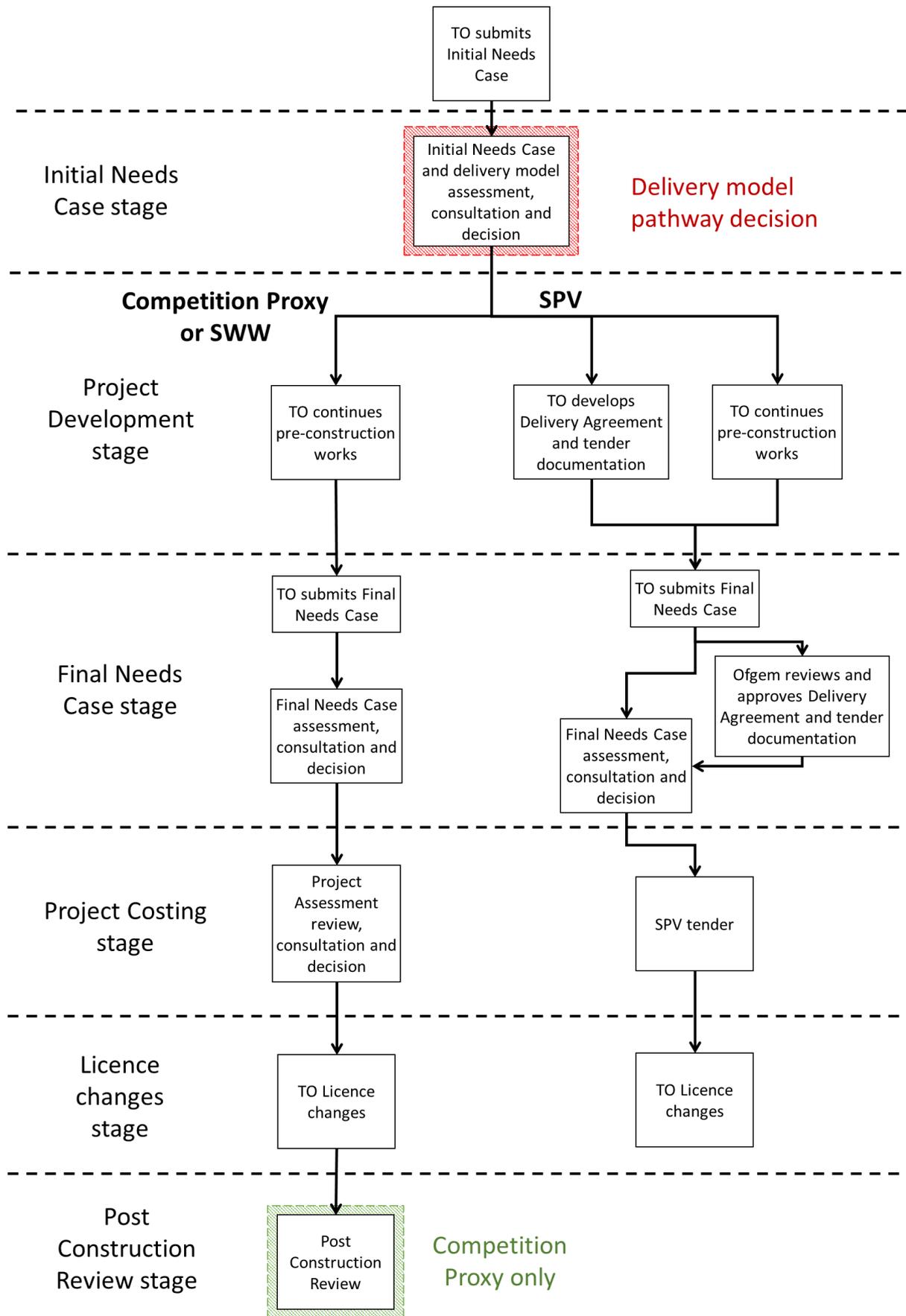


Figure A1.2 Approach for projects without an INC

