

9th November 2018

Matthew Ball
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Ofgem
9 Millbank
London SW1P 3GE

Dear Matthew,

ENERGY NETWORKS ASSOCIATION RESPONSE TO CONSULTATION ON EXTENDING COMPETITION IN ELECTRICITY TRANSMISSION: COMMERCIAL AND REGULATORY FRAMEWORK FOR THE SPV MODEL

Energy Networks Association (ENA) represents the ‘wires and pipes’ transmission and distribution network operators for gas and electricity in the UK and Ireland. As private companies providing a public service, our members are responsible for the critical national infrastructure that delivers these vital services into customers’ homes and businesses. This response, to the above consultation, is on behalf of a majority of our electricity distribution and electricity transmission members¹.

Introduction

ENA members welcome the opportunity to respond to this consultation on the commercial and regulatory framework for the Special Purpose Vehicle (SPV) model, in onshore electricity transmission. Within our response we have sought to set out the collective views of our electricity network members. Our response therefore lays out key common points on which there is broad agreement between our members that respond to issues raised by the outlined approach.

Competition

As a principle, our members are supportive of considering new approaches that will deliver clear benefits to consumers. As such, ENA recognises that competition, where appropriately applied, has the potential to deliver benefit for consumers, and is already well established across GB’s transmission network. However, although there is more detail in this consultation, than the earlier proposals, we believe there remain significant issues and unanswered questions that need to be addressed by Ofgem, in detail, before implementation could seriously be considered. We also question whether the SPV model proposed, would in fact promote competition at all.

We present below a range of observations on the SPV model that challenge the assumption that it would provide a clear benefit to consumers when compared with the current Strategic Wider Works (SWW) mechanism under the RIIO1 Transmission Price Control or the developing Competitively Appointed Transmission Owner (CATO) regime. We recognise that

¹ These are Northern Powergrid, Scottish Power Energy Networks, UK Power Networks, Scottish & Southern Electricity Networks, Western Power Distribution and National Grid.

it is the uncertainty around the timing of new legislation needed to implement CATO that has led the regulator to explore other approaches. It is therefore reasonable to conclude that by definition the SPV model is, at the very least, suboptimal in comparison with either CATO or the existing tried and tested SWW regime. If Ofgem is committed to introducing further competition across the transmission network, then we would recommend that they do this through the appropriate legislative framework, rather than introducing inadequate interim models, in the meantime.

We therefore have fundamental concerns about the outlined SPV model and the lack of recognition and analysis of the complex financial, commercial and technical interplay that it would create between the electricity transmission price control mechanism, the other sector specific price controls and wider markets. We also believe there are areas of weakness in the SPV model as set out in the consultation that will lead to delays and additional complexities in the development and delivery of strategic network infrastructure, and significantly reduce or remove the estimated financial benefit to consumers.

Consumer Benefit Case – Lack of Evidence

We remain unconvinced that the SPV model will deliver consumer benefit over the current SWW process, and the limited detail in Ofgem's Impact Assessment does little to persuade us otherwise. The premise of the proposed model relies on companies bidding in with low rates of return. There is little detailed consideration of the allocation of risk and the impacts and/or behaviours the proposed framework model may drive in the SPV, TO and the wider networks. The allocation of risk to non-TO entities, in an attempt to produce a low headline WACC seems to be the primary objective. However, the cost of such a transfer of risk to all parties, particularly the TOs, has not been recognised. The implications of introducing the SPV into a RIIO-integrated network setting therefore needs to be explored and understood fully.

What would be the impact on the host TO's ability to finance activities? For example, markets are likely to factor the increased risk of the TO's complex contractual relationship with the SPV into the returns they expect when investing in TOs. This will increase the future cost of capital for TOs, which may result in no overall net benefit to consumers. As the current proposals do not envisage funding TOs for the additional risk they bear, it seems reasonable to expect the presence of an SPV to have a negative impact on credit metrics and financeability.

Company Responsibility

This SPV model relies on potential bidders using strategies that achieve low financing rates, thereby presenting a lower headline project cost. For example, bidders are expected to use high gearing, resulting in an increased risk of financial distress and SPV default. In fact, under the current proposals, Ofgem does not intend to monitor the financial health of the SPV, in the way that it does for the TOs. Under this scenario, the TO would need to step in and we would expect that Ofgem would carry out another tendering process to appoint a new owner/operator, which would have significant associated costs for consumers. An SPV may also achieve lower headline costs through the use of sub-standard assets or limited maintenance regimes, thereby exposing generators, owners and operators to an increased risk of asset failure, which would have a significant impact on wider network resilience,

safety and other key performance parameters. It will also be important to ensure that at the point of handover, the asset is in an acceptable condition to the TO allowing for the ongoing safe, efficient and reliable operation of its network.

Given the objective is to realise additional cost efficiencies through the use of competition it is difficult to understand why the incumbent TO would be excluded from bidding. Whilst any potential conflict of interest would need to be mitigated, this would not be insurmountable and TOs have a proven track record of implementing business separation measures.

Complexity

We believe the introduction of the SPV model would create a significantly more complex regulatory framework. The implementation of the SPV model will also lead to a greater number of interfaces and heightened complexity in co-ordination and operation, making the model markedly more difficult and costly to implement than the proposed CATO model. It will also lead to significant challenges and risks in the operation of the transmission asset, given that it will be part of a wider transmission network. How is the SPV to operate the asset? Is it expected that the SPV will need to create and operate its own control room for this asset? If so, how will it interface with the TO and the System Operator? This will result in increased administrative, financial and operational complexity and a slower process overall, with knock-on delays to the connection of new lower carbon generation and associated negative environmental and financial impacts.

Conclusion

Whilst ENA members are supportive of competition and welcome proposals that are in the best interests of consumers, the suggested (unsubstantiated) benefits and clear weaknesses of the SPV model need to be weighed against any additional risks to the successful delivery of large transmission projects and the connection of new generation, and any resultant detrimental delays and increased costs that will be passed to consumers as a result.

Furthermore, in light of last month's budget announcement that future Private Finance Initiative (PFI) and PF2 contracts are to be abolished, we are keen to understand Ofgem's intentions for the SPV model given that it has been heavily influenced by PF2 in particular.

Overall we are of the view that the SPV model ultimately fails in a number of significant aspects. Although we recognise the potential of competition to improve outcomes for consumers, we do not believe the SPV model as would achieve this.

If you have any questions on points raised in this response, please contact John Spurgeon, Head of Regulatory Policy at ENA: john.spurgeon@energynetworks.org.

Yours sincerely,



David Smith
Chief Executive