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Dear Matthew

Extending competition in electricity transmission: commercial and regulatory framework for the SPV model

Frontier Power is an independent operator and asset manager of five OFTO assets that were competitively tendered and has been following and supporting Ofgem's proposals to introduce competitive tendering to onshore electricity transmission projects.

We are pleased that, notwithstanding the timing constraints on legislating for full implementation of the CATO framework, Ofgem is looking at innovative ways to secure the benefits from competition in onshore transmission as soon as possible.

We remain keen to participate in competitive onshore transmission projects under any suitable arrangements brought forward by Ofgem.

Our responses to Ofgem's proposals for the possible introduction of competitive approaches to delivering onshore transmission projects are given below and we are happy for our response to made publicly available.

Yours sincerely,

Iain Cameron

Chief Operating Officer

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Commercial Framework

Question 1: What are your views on the commercial framework as set out in the accompanying Agilia report?

The framework appears appropriate. We note that the proposed SPV model is similar to the 'late' CATO model and broadly comparable to the OFTO model which has led to material reductions in the long-term costs of those projects. These have come from optimised financing arrangements, including the cost of equity, debt, appropriate risk apportionment and insurance as well as innovative contractual operational arrangements and have exceeded Ofgem's initial expectations. It is reasonable to expect that similar benefits could be delivered from the SPV model.

Question 2: Do you agree with the scope of our role in the SPV model?

Ofgem has an important role to play in ensuring that appropriate land and consent arrangements are developed by the TO to ensure as smooth a project handover as possible but this needs to be done in a timescale compatible with overall project development. The possibility of re-opening major consent issues which arose from Ofgem's consideration of the Hinkley Seabank use of (already consented) T Pylons could have resulted in significant uncertainty and delay which would have adversely impacted the project's financeability.

Question 3: Do you agree with the scope of the Independent Technical Advisor? Do you have examples you can share of Independent Technical Advisors working well or not so well, and any examples of lessons learned from this approach?

The scope of the ITA as defined in the consultation documents appears to be appropriate.

Question 4: What are your views on operational period incentives for the SPV?

We note that the proposed availability incentive mirrors the OFTO mechanism and that for the proposed CATO model. This has proved an effective incentive for the efficient financing and operational performance of OFTOs because of the underpinning provided for output-adjusting events to allow for revenue adjustments in certain defined circumstances. We are pleased to note that the Agilia report (p27, para 10(a)) envisages similar mechanisms being applied to the SPV model.

In principle we would be happy to see other incentives for SF6 leakages or other areas on a case-by-case basis as proposed.

Question 5: What are your views on where there may be consumer value in a target cost rather than fixed price model?

We strongly support the fixed price model approach as this, along with uncertainty price re-openers for low risk / high impact events envisaged in the Agilia report, is critical to providing the certainty required for efficient project financing. The target cost approach does not provide the same certainty.

Question 6: What are your views on possible TO and SPV enhanced alignment options?

We agree with Ofgem's conclusion (para 3.58) that no enhanced alignment mechanisms are necessarily required for the SPV model to deliver consumer benefits.

We think there is no benefit from NGET retaining an equity interest in the SPV as any possible incentives from NGET involvement would easily be outweighed by the management of conflicts of interest and additional managerial complexity. No such incentive mechanism has been needed in the OFTO regime and it is not necessary here. If NGET needs to be incentivised to ensure effective tender and project delivery, then we think this would be better done via a defined percentage of savings achieved from the SPV model.

Similarly, we do not think the Alliance Agreement would give any benefit and it appears overly complex.

Question 7: Are there any other points we should consider within the commercial framework?

We think that Ofgem should consider longer revenue periods than 25 years. Onshore transmission assets typically have design operational lifetimes of forty years or more. The Fort McMurray West 500 kV Transmission Project in Alberta competitively tendered in 2014 has an operational revenue period of 35 years and, including the consenting and construction period, the concession is for approximately 40 years.

We believe that a longer concession period would increase the consumer benefit from the project by improving the debt financing packages available. We would like to see Ofgem re-visit its earlier CATO work to check the validity of its conclusion that the shorter, 25-year revenue period, '*delivers the best value for consumers within the debt and equity markets*' (par 3.16, https://www.ofgem.gov.uk/system/files/docs/2017/08/hinkley_seabank_consultation_2017.pdf).

Regulatory Framework

Question 1: What are your views on the regulatory framework as set out in this consultation, and how it interacts with the commercial framework?

No comment.

Question 2: Do you agree with the scope of TO obligations during the pre-tender, tender, construction period, and operational period?

We think that additional consideration needs to be given to how the procurement activities of the project itself will best fit with the requirements of the SPV Procurement process and overall project timescales.

If the project were being wholly developed by the incumbent TO (or another developer altogether) the normal programme sequence would be to move to detailed design and the initiation of a procurement process (including possibly early ordering of some long lead-time items) once the outline design and majority of consenting and land access issues had been settled. Although the SPV participant will undertake some more detailed design work and cost estimation as part of its bid this is unlikely to be of sufficient detail to run a full procurement process during its SPV bid and to let tenders immediately on bid success. There will thus be a delay in moving to the project's procurement phase compared to a TO only progrtamme.

If project timescales are tight it might be necessary for the TO to conduct some early procurement activity and pre-ordering of material for subsequent handover to the successful SPV. However, it would be better from the bidder's perspective, and thus in terms of consumer costs, if project timescales were such that full control of procurement remained with the SPV and that the project programme was designed accordingly. This is an issue specifically for HVDC projects with long lead time components and this point was discussed in Ofgem's consultation on the CATO proposals in 2015/2016. At that time we agreed with the proposal that such projects could still be tendered by adapting the late CATO model to require the SO to procure certain long lead time components and transfer the contract(s) for these to the CATO, presumably prior to construction. However, such procurement by the SO should follow the form of contract(s) that would best enable the CATO to allocate the appropriate risks to the contract to ensure that the risk profile for the CATO is not adversely affected, which would increase the cost of capital for the CATO. In the context of the proposed SPV model, we remain of the view that if the TO is required to undertake some procurement in advance of the tender process then any such procurement should follow the form of contract(s) that would best enable the SPV to allocate the appropriate risks to the contract to ensure that the risk profile for the SPV is not adversely affected, which would increase the cost of capital for the SPV.

Question 3: Do you agree with our approach to structuring the TO's allowances, including both base revenue and cost adjustments?

No comment.

Question 4: Do you agree with our proposed approach to operational period incentives, including interactions with the TO's price control incentives?

Our views on operational incentives for the SPV are set out in response to Question 4 on the Commercial Framework. We have no comment on the TO's allowances and interaction with its price control incentives.

Question 5: What are your views on our proposed arrangements for the period after the end of the SPV's revenue term?

Obviously clear handback criteria would need to be defined if the asset is to be returned to TO day-to-day operational management after 25 years but, as we have said in response to Question 7 on the Commercial Framework, we believe that a longer concession period would benefit consumers.

Question 6: What are your views on our conflict mitigation proposals?
- Would the TO conflict mitigations proposed sufficiently mitigate conflict where a TO bidder seeks to participate in an SPV tender in its own geographical area?
- And if not, what different/additional arrangements would be needed?

We do not think conflict mitigation proposals are needed as we strongly believe that Ofgem should adopt a similar approach to OFWAT in effectively excluding incumbent water companies from bidding in their own geographical areas.

Having participated in OFTO tenders since their inception, our experience of market conditions is that there is likely to be a significant appetite from independent investors to bid for onshore transmission SPV opportunities. Allowing TOs to bid in their own geographic areas would reduce, not enhance, competition by undermining confidence in the tender process as well as adding considerably complexity through the sort of mitigation mechanisms envisaged.

We would, of course see no objection in each UK TO bidding for such opportunities within the territory of other UK TOs where it would enhance competition without the need for complex mitigation mechanisms.

Question 7: Do you think that any changes to industry codes or standards are needed, or would be beneficial, for the SPV model?

No comment at this stage. We assume these details will be addressed in due course.

Procurement Principles

Question 1: Do you agree with our proposed procurement principles?

We note the proposal that the selection of preferred bidders should be based on the most economically advantageous tender, not just cost. We are also aware that, whilst this approach has been used for OFTO tenders to date, Ofgem's approach to TR6 is proposing to move to an approach where all non-price criteria are assessed on a pass/fail basis with the lowest Tender Revenue Stream (TRS) being the single deciding criteria once all other requirements are passed. This lowest TRS approach is similar to that used in the Fort McMurray West 500 kV Transmission Project tender and, we believe, gives greatest clarity and incentive to bidders resulting in lowest costs and greatest consumer benefit. It also makes the choice of level to be set to pass the non-price criteria to be rigorous but no higher than technically necessary.

Question 2: Are there any other areas where we should be setting firm requirements regarding procurement of the SPV, or where additional guidance would be helpful?

Further details on the availability incentive mechanism as envisaged in the Agilia report will be necessary in due course, where we would expect to see appropriate forms of relief for unforeseen and unforeseeable evnts consistent with the Exceptional Events provisions under the OFTO licence.

Question 3: Are there any areas included in this chapter where we should not be setting requirements regarding procurement of the SPV?

No comment.