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Dear James

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

This response is from SP Transmission (**SPT**), the onshore transmission owner for the Central Belt and South of Scotland. We welcome the opportunity to respond to this consultation and recognise the benefits of competition, which we use extensively to consumers' benefit. We believe we have the skills and experience to help drive improvements throughout the national transmission network and will continue to play our part in delivering effective competition, in the future.

However, for the many reasons, set out in this response, we do not believe that the Special Purpose Vehicle (**SPV**) model will deliver effective competition that benefits consumers today or in the future. In our view, the SPV model is not lawful, practical or cost effective.

We consider it fundamental that Ofgem acts within the statutory framework in 'extending competition in electricity transmission'. We are strongly of the view that Ofgem should be waiting until Parliament has the relevant legislation in place before pressing ahead with any proposals in this area.

The remainder of our response is focused on the proposed SPV model. Our response is set out in three, related, documents: (i) this letter which summarises some overarching concerns which we have identified with the SPV model; (ii) a detailed Annex responding to Ofgem's questions on the commercial, regulatory and procurement framework; (iii) a further letter with our views on the SPV aspects of Ofgem's Impact Assessment (IA).

SPT has fundamental concerns with Ofgem's proposals for the SPV model, primarily that consumers will not benefit, and their interests are actually put at risk, for three main reasons:

- the SPV model is unlawful;
- the SPV model is not practical;
- the SPV model will be significantly more complex and expensive than Ofgem anticipates.

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We have outlined these concerns in greater detail below:

The SPV MODEL IS UNLAWFUL

SPT disagrees, in principle, with Ofgem's proposals for the SPV model. We consider that it would be unlawful for Ofgem to require or compel any TO to manage its affairs in this way, for the following reasons:

The SPV model is an unlawful divestment of regulatory responsibility by Ofgem

A key element of the Electricity Act 1989, (**EA'89**) regime is the creation of Ofgem as an independent regulator which is empowered to regulate critical industry activities, such as transmission, in the interests of consumers.

Under the SPV model, proposed by Ofgem, a TO could be compelled to delegate the performance of its licence obligations, against its will, to an SPV. If that SPV were then to cause a breach of the TO's licence, the TO could not realistically be sanctioned for that breach. On no view would a sanction against the TO be proportionate. Yet Ofgem rightly recognises that any sanction must be proportionate.¹ Nor could Ofgem punish the SPV because, as Ofgem also recognises², Ofgem has no direct relationship with the SPV. In summary, under the SPV model, Ofgem would not be able to secure compliance with the TO licence.

Accordingly, by implementing the SPV model, Ofgem would be abdicating its regulatory responsibility, both generally and in particular the responsibility conferred on Ofgem under section 25(1) EA'89.

It is a core principle of administrative law that a public body cannot abdicate or fetter its statutory duties or powers. For this reason, the SPV model is fundamentally and fatally flawed.

The SPV proposal unlawfully circumvents the statutory licensing regime

The SPV is making its transmission assets available for use. This activity is licensable under EA'89 yet Ofgem appear to propose that the SPV is not licensed. Again, this is unlawful.

Ofgem explain that, "*the SPV would have responsibility for the day-to-day O&M of the assets and that it should be allowed to perform its functions under the DA without undue interference from the TO.*"³ It follows that the TO's role in the SPV's activities will be limited. Ofgem propose that the TOs retain "*operational control*" of the relevant part of the transmission system by: (i) retaining ownership of the assets; (ii) having rights to information from the SPV; and (iii) having step in rights.⁴ This must mean

¹ See Ofgem, "Extending competition in electricity transmission: commercial and regulatory framework for the SPV model" 4.53. See also Ofgem's Enforcement Guidelines.

² Ofgem, "Extending competition in electricity transmission: commercial and regulatory framework for the SPV model" 4.53.

³ Ofgem, "*Extending competition in electricity transmission: commercial and regulatory framework for the SPV model*". 4.49-4.50.

that the SPV (and not the TO) has possession of the relevant part of the transmission system, unless the TO has “stepped in”.

The fact that the SPV has possession of the relevant part of the transmission system can only mean that the SPV is making available its part of the transmission system for use and so is undertaking an activity which requires a licence under EA’89. Ofgem’s proposal to permit the SPV to engage in transmission without a licence, therefore, unlawfully circumvents the EA’89 licensing regime.

THE SPV MODEL IS NOT PRACTICAL

SPT has also identified a number of significant issues which we consider make the SPV proposals unworkable in practice. Our concerns are explained below:

The circumvention of the existing regulatory structure for electricity transmission will increase operational risk

An important consequence of this “circumvention” is that it does not appear that the SPV will be directly subject to the existing detailed arrangements for transmission in Great Britain. These arrangements are designed to maintain the highest standards of safety and reliability of supply and address the material operational risks of transmission. Unlike the SO, the TOs and OFTOs, the SPV will not be directly subject to these arrangements, despite the fact that it is undertaking material transmission activity. This must increase operational risk.

Ofgem’s proposals do not appear to be supported by a detailed review of these arrangements. This is difficult to understand given that the existing framework has been developed with a great deal of care, over many years, by experts at Ofgem, the transmission licensees and the wider electricity industry.

As Ofgem is aware, electricity transmission in GB is delivered by two different types of transmission licensee: the System Operator (**SO**), National Grid, who “co-ordinates, and directs, the flow of electricity”⁵; and the Transmission Owners (**TOs**) who own the transmission assets in their respective areas and “make” those assets “available” to the SO⁶.

This arrangement was put in place under an Ofgem led reform, British Electricity Trading and Transmission Arrangements, (**BETTA**). Ofgem’s BETTA programme involved significant work on the part of Ofgem, the transmission licensees and the wider electricity industry to put in place robust arrangements under which TOs would make available their systems to the SO, so that the British transmission system was operated on a unified basis.

SPT is concerned that the SPV will evade certain key features of the BETTA structure. They are as follows:

⁴ Ofgem, “Extending Competition in electricity transmission: commercial and regulatory framework for the SPV model” 4.49 - 4.50

⁵ A role described in section 4(3A)(a)(EA’89).

⁶ Section 4(3A)(b) of the EA’89.

EA'89 duties

The EA'89 section 9 statutory duty on SO and TOs to “*develop and maintain an efficient, co-ordinated and economical system of electricity transmission*”⁷ applies to all transmission licensees. This is a critical overarching provision that governs all elements of a transmission licensee’s activity. This provision will not apply to the SPV.

Transmission licence duties

The transmission licences contain a range of relevant obligations to ensure that the BETTA arrangements operate appropriately. None of these will apply to the SPV.

The TOs’ provision of transmission services to the SO is more specifically described in their licences. The TOs must:⁸

- provide transmission services in accordance with the STC (it is a licence requirement to comply with the STC);
- make sure the transmission systems are fit for purpose;
- enable the SO to issue directions to configure the transmission systems and give effect to any such directions; and
- allow the SO to obtain information it needs to co-ordinate and direct the flow of electricity onto and over the transmission system.

Again, none of these provisions will apply to the SPV.

TOs are also obliged to plan and operate their system in accordance with the STC and the National Electricity Transmission System Security and Quality of Supply Standard,⁹ and are obliged to offer terms for connection of users to the SO. Ofgem can determine such terms if there is a dispute.¹⁰ These important obligations will not apply to the SPV.

STC duties

Considerable additional detail about how both the SO and all the TOs shall comply with their various obligations is set out in the STC and the associated procedures. Compliance with the STC is a licence requirement and also a contractual requirement. The STC contains 51 detailed procedures which provide specification for a range of important matters such as how operational switching is effected, (STCP01-01), Black Start (STCP06-01), Alarm and Event Management, (STCP02-01), Site Public and Environmental Safety, (STCP09-2), and Outage Planning, (STCP11-1). These procedures have been

⁷ Amongst other things, see section 9(2) EA'89.

⁸ TSLC D2.

⁹ TSLC D3.

¹⁰ TSLC D4A and D4B

kept up to date and are the subject of regular review and Ofgem oversight.¹¹ It appears that the STC will not directly apply to the SPV.

In this regard, the asymmetry of the position of OFTOs compared to SPVs is notable. OFTOs must be licensed and comply with the detailed BETTA framework. This reflects a logical policy position – that electricity transmission must be conducted, according to consistent arrangements, that have been carefully designed to ensure that the GB transmission system is operated safely, efficiently and securely.

The existing regime to protect consumers against network company financial distress will not apply to the SPV

Ofgem has chosen a structure, which excludes its direct role in ensuring energy network companies' financial health. The transmission licence includes provisions to ensure that financial strength is monitored by Ofgem and corrective action is taken when required. The Energy Act 2004 also contains provisions in relation to the administration of transmission licensees which dis-apply aspects of "normal" insolvency procedure. These provisions will not apply to the SPV as it will not hold a transmission licence. The structure also excludes its ability to apply for an energy administration order pursuant to section 156 of the Energy Act 2004.

Application of the SPV model will increase the risk to customers through the disapplication of important licence conditions on TOs designed to protect the customer as the SPV will not be subject to the Transmission Licence Condition B7: Availability of Resources.

Condition B7 contains important protection mechanisms including that a licensee shall at all times, act in a manner calculated to secure that it has available to it, such resources to properly and efficiently carry on the transmission business. To comply with this licence condition the licensee must submit a certificate from its Board to confirm it has sufficient financial resources and financial facilities to carry on the transmission business for a period of 12 months from the date of this certificate.

In addition Condition B7 imposes obligations including: Obligation to report any adverse circumstances; Certificates for the Authority in relation to dividends; and Requirement to maintain an Intervention Plan. Other relevant financial licence conditions include: Condition B6: Restriction on Activity and Financial Ring Fencing; Condition B8: Undertaking from ultimate controller, Condition B9: Indebtedness and Condition B10: Credit Rating.

¹¹ These transmission arrangements built on the extensive work of Ofgem and the industry from restructuring and privatisation onwards. As an example, the inter-operation of the Scottish and English transmission systems were the subject of careful analysis and regulation from restructuring/privatisation up to BETTA Go-live. These arrangements were documented in the licences, the Grid Codes, the System Operation Agreement and the British Grid Systems Agreement.

These licence conditions impose desirable restrictions, including being unable to make a dividend payment, without first submitting a pre dividend certificate. This certificate confirms its compliance with relevant licence conditions and ring fences the finances, in the event certain conditions are not met.

The SPV model will allow potential owners of critical infrastructure to the electricity transmission network to circumvent these very relevant and appropriate licence conditions which are designed to protect against inappropriate shareholder behaviour and have served the consumer well since inauguration.

The treatment of the transmission 'asset' for accounting purposes

Given the complex contractual relationship associated with the transmission 'asset' under the SPV model, this additional risk to the TO will need to be appropriately reflected within SPT's accounts. We understand the asset is to be owned by the Licensee and, through 'step in' rights, the overall risk is retained. Therefore under International Accounting Guidance a separate (ring fenced) fixed asset will be recognised in SPT's balance sheet and depreciated over its useful (operational) life. We anticipate the operational life will be far in excess of the proposed SPV contract period. The carrying value of this distinctly separate, ring fenced, asset will be subject to regular impairment reviews and will likely be subject to impairment in the accounts of SPT following the cessation of the shorter SPV period when no future cash flows will flow.

We are keen to understand if Ofgem has given any thought as to how this 'asset' is to be treated, for accounting purposes. It is important that the actual risk associated with the complex arrangement, is accurately reflected to shareholders.

THE SPV MODEL WILL BE SIGNIFICANTLY MORE COMPLEX AND EXPENSIVE TO OPERATE THAN OFGEM ANTICIPATES

SPT's experience of using sub-contractors, developed over many years of establishing and managing projects of this scale, clearly shows that things sometimes do not go as planned. Technical, commercial and legal issues will arise which will require good-will and flexibility on both sides to resolve. Yet such issues could be difficult to resolve, in practice, under the SPV model as each party has a different value proposition. The TO is seeking procurement of a robust, enduring and efficient asset to a well understood and acceptable standard, whilst the SPV is aiming to deliver an asset at the lowest short term cost with cash flow and margins maintained as a premium. Some of the issues we consider likely to arise, are set out below. Ofgem's Impact Assessment does not appear to recognise such complexities and the additional costs that these issues will unavoidably create:

Project duration and re-openers

Experience suggests that it is almost certain that there will be requests for the TO to adjust the SPV's revenues accordingly. There will be additional costs of managing all such requests, even where unsuccessful, as well as the increased overall cost where such requests are successful. As with many PFIs, circumstances may also change such that the initial deal does not remain in customers' best interests, especially as efficiency incentives reduce.

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Increased TO risk

The TO's exposure to risk increases under the SPV model. It is expected to manage performance of an asset over which it does not have day to day control and yet take responsibility for the SPV's actions. Not only will all of the TO's activities have to be remunerated, the increased level of business risk could potentially impact on the costs of operating the TO. As mentioned above, it will also be important that the level of increased risk, associated with this asset, is reflected appropriately to shareholders.

Tender re-runs and SPV insolvency

As Ofgem anticipates, it may sometimes be necessary to re-run tender processes, increasing the time and cost of delivering these projects. Further, there could potentially be instances where the SPV could become insolvent. Particularly as Ofgem does not intend to regulate and supervise the financial strength of the SPV, as detailed above. There is no guarantee that such an event could be managed without any impact on consumers and, in any event, would increase overall system costs.

NEXT STEPS

In light of the Chancellor of the Exchequer's announcement in the latest Budget, of October 2018, to abolish future PFI and PF2 contracts given the compelling evidence that these contracts neither deliver value for taxpayers nor genuinely transfer risk to the private sector, we are keen for an update from Ofgem as to how this announcement impacts on their proposals for introducing the SPV model. Our views on the SPV model, aligns with the Chancellor's views. We do not consider that the SPV model will deliver value for consumers, nor does the proposed framework genuinely transfer risk to the SPV model, given that it is unlikely that any contractual Development Agreement could be written in a way which fully 'passed through' the various obligations which the TO is under; e.g. in Section 9 of the EA'89 and Standard Condition D2 of its licence.

We are therefore of the opinion that Ofgem's proposals for the SPV model must be reconsidered in light of this Budget announcement, and the reasons we have laid out in this letter. We look forward to a timely update from Ofgem on this.

Please feel free to contact me should you have any questions in relation to our response to this consultation.

Yours sincerely,



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