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Dear James

Impact Assessment on applying the Special Purpose Vehicle model to future new, separable and high value projects

This response is from SP Transmission (SPT), the onshore transmission owner for the central belt and South of Scotland. We welcome the opportunity to comment on Ofgem's Impact Assessment (IA) on applying the Special Purpose Vehicle (SPV) model to future new, separable and high value projects. Given the limited evidence contained within the IA, we are unable to share extensive comments on the document. We have instead used this response to share our views on some of the key assumptions, on the SPV model, made within the IA. We intend to provide comments on the Competition Proxy Model (CPM) under separate cover.

Cost of Capital assumptions

Ofgem notes in the IA that most of the cost efficiencies for the SPV model relate to assumed reductions in the cost of capital. Ofgem produces separate cost of capital ranges for the operational and construction phases of the projects, reflecting Ofgem's views of the material differences in risk between these two phases, and the impact on cost of debt, equity and gearing.

In the IA, Ofgem suggests that the SPV model can deliver financial savings for consumers by reflecting efficient market-based costs. Ofgem considers that setting a project specific cost of capital through the SPV model has four advantages which will deliver relatively low financing costs.

The first three claimed advantages relate to low cost of debt, as to which Ofgem refers to:

- (i) the historically low cost of debt currently reflected in the market is reflected in the charges consumers face;*
- (ii) this low cost of debt can be locked in for the length of the construction, and then the full operational period of the project;*
- (iii) the allowed cost of capital during the operational period appropriately reflects the low operational rates of return that have been determined through competitive processes.*

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It is not at all clear that any of those factors will hold. In particular, we think it is important that Ofgem provides further details to explain the basis on which it has reached its view on today's cost of debt. Will this be the prevailing cost of debt at the time any future SPV is established? Will it be possible for a SPV to lock in this cost of debt for up to 30 years, given the expectation that the SPV will re-finance during the project term? We also think it is important that Ofgem further explains the assumptions it has made in relation to the likely amortisation of debt, particularly in the construction period, and the costs which can be expected to flow from that.

The fourth claimed advantage relates to the OFTO regime, as to which Ofgem refers to:

(iv) evidence from the OFTO regime, interconnectors, and Private Finance Initiative (PFI) Public Private Partnership (PPP) projects suggests that a higher gearing (ratio of debt to equity) than the notional 60% assumed in the TOs price controls is more appropriate for new, high-value, separable infrastructure projects. As the market rates for debt are currently low and debt is normally cheaper than equity, the higher gearing would drive significant savings under CPM and SPV.

Ofgem is assuming that higher leverage means a lower cost of capital, because debt is cheaper than equity. However, the cost of equity increases with financial leverage, as with an increasing debt interest cost and prior claims on cash-flows, equity returns become riskier (frequently recognised by accountants and economists as the 'Modigliani-Miller theorem').

The IA assumptions on the cost of capital range during the operational phase appear to be derived from CEPA's operational cost of equity assumption, which is inferred from OFTOs' equity IRRs. However, given that Ofgem has provided no reference for the equity IRRs for OFTOs or any explanation as to how the equity IRRs were derived from the OFTO bids, SPT cannot accept this evidence, which does not allow us to understand the decision Ofgem is proposing to make. We ask Ofgem to release further details on the OFTO's equity costs which would allow us to test and verify Ofgem's (and CEPA's) assumptions. Without such information, the OFTO IRRs provide an unsubstantiated and unreliable method to determine the cost of equity for onshore networks.

We do not consider the OFTO regime to be an appropriate comparator for electricity transmission. At a technical level, onshore Strategic Wider Works (SWW) projects are likely to be integral to the wider network, with various system and customer dependencies. They would therefore be significantly more complex to design, build and operate than OFTO systems.

In addition, there are some key differences in the licences of TOs and OFTOs, which will have an impact on the costs and risks of those businesses and so the cost of capital which they require. For example (i) TOs are under an absolute obligation to maintain an investment grade credit rating, whereas OFTOs are not¹. (ii) OFTOs can be exempt from connection duties where the cost of making the connections breaches a certain threshold, whereas TOs benefit from no such exemption². (iii) TO's ability to grant security over their assets is more limited than OFTOs³.

¹ SLC B10 v OFTO E11.

² SLC D4A(4) v OFTO E17(5)

³ SLC B3(2),(3),(6)-(8) v OFTO E4

Capital and operational cost savings

Without explicit evidence of any capital cost savings, as SPT has outlined above, it follows that the “10% capital and operational cost savings” in the SPV model, assumed by Ofgem in the IA, must come from savings during the operational phase of the project. However, given our experience as a transmission network operator, we disagree that the SPV model will deliver any operational savings, above and beyond savings that SPT is currently able to deliver. SPT benefits from economies of scale, given the magnitude of contracts and cost efficiencies which come from tendering for works across our entire transmission network. By contrast, the SPV’s operational responsibilities relate to only a very small section of a transmission network.

In particular, we note that paragraphs 3.6 to 3.9 of the IA list assumed qualitative benefits of an SPV contracting with a wider pool of supply chain participants than would otherwise engage with a TO. These assumptions run counter to SPT’s experience of achieving procurement efficiencies. Has Ofgem’s work considered the relative benefits of (i) having a repeat buyer such as a TO achieving economies of scale; and (ii) using a disaggregated, rather than ‘big bang’ approach to procurement in order to keep the supply chain competitive?

The proposed costs of the Independent Technical Advisor

The IA suggests the estimated costs of the appointment of the Independent Technical Advisor (ITA), over the lifetime of the project, will be between £0.5m and £1m, with little detail as to how these figures were derived and what they include. For example, do these figures solely account for overseeing the delivery of the construction and operation of the asset or do they also account for any potential disputes between the TO and the SPV during the operational period, and difficulties or disputes during the complex transaction of hand-over? The number of disputes that may be referred to the ITA, and the efficiency with which they could be resolved, could not be accurately quantified at this point, given the unprecedented nature of the role. It is precarious to presume that an ITA would commit to a fixed price for the full period of 25+ years. In determining the value of this model to consumers, it is important that all costs are reflected and transparently detailed in the IA.

Cost overruns and revenue adjustments

The experience from the Private Finance Initiative (PFI) and other similar regimes has shown cases of cost-escalation and/or underpricing. Given the complexity and duration of the proposed SPV model, SPT considers that cost overruns and delays during the tendering exercise, the construction and operational and maintenance periods are inevitable. Ofgem evidently agrees, given that the proposed SPV model regulatory framework offers provisions for the TO to allow for revenue adjustments for the SPV. However, it is unclear to what extent Ofgem has included these additional costs within the IA. Again, we would wish to see further evidence from Ofgem as to how these costs have been derived, and what they include.

Other IA Issues

We have a number of other questions in relation to the approach Ofgem has taken to the IA for SPV. These are set out below and we look forward to Ofgem providing more detail on these and the other points raised in this response:

- What approach has Ofgem taken to assessing the overall costs of unsuccessful bidders? This cost should be included in assessing the costs and benefits of the SPV as it is a societal cost.
- We have identified a number of aspects of the SPV model, which are set out in our accompanying response to the SPV consultation document. These include the potential for duplication of control room costs which will inevitably mean that the SPV will be more complex, and expensive, than appears to have been assumed. What plans does Ofgem have to keep its IA under review as the details, and therefore the anticipated costs, of the SPV model become clearer?
- To what extent has Ofgem addressed:
 - Whether it would be more effective to wait for Parliamentary time to progress the CATO model, which avoids a range of complexities that arise under the SPV model?
 - The costs inherent in a novel and complex arrangement that does not fit with the existing, well understood, framework for electricity transmission?
 - The inability to review the SPV's costs – via the price control processes.
 - The loss of existing efficiencies arising from the arrangements put in place by the TOs.
 - The fact that the scope of the 'high-level design' to be provided by the TOs is unclear. It follows that the likelihood of receiving clear and comparable bids with appropriate price certainty cannot be fully assessed.

2018 Budget announcement

PFI and in particular, the PF2 regime, has clearly heavily influenced the design of the SPV model. For example, the Agilia report is explicitly clear that for the proposed SPV model, *“the suggested risk allocation has drawn upon principles from a number of infrastructure delivery models including the PF2 model, the Ofgem consultation on the CATO model and Thames Tideway Tunnel”*.

In light of the Chancellor of the Exchequer's announcement in the latest Budget, in October 2018, to abolish future PFI and PF2 contracts given the compelling evidence that these contracts neither deliver value for taxpayers nor genuinely transfers 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, as set out in detail in our response to the SPV model consultation which accompanies this letter, align 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 Electricity Act 1989 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. We look forward to a timely update from Ofgem on this.

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Network Planning & Regulation

Should you have any questions in relation to this response, please do not hesitate to contact me.

Yours sincerely,

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