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By email only to NTIMailbox@ofgem.gov.uk

Dear Matthew

Extending competition in electricity transmission: commercial and regulatory framework for the Special Purpose Vehicle (SPV) Model

Thank you for the opportunity to respond to the above consultation. This response is on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc. We are the UK's largest electricity Distribution Network Operator (DNO) group, dedicated to delivering a safe, secure and sustainable electricity supply to 8.3 million homes and businesses.

Ofgem's principle objective is to protect the interests of existing and future consumers, which includes promoting effective competition, where appropriate. The UK's regulatory framework for energy networks, RIIO, is internationally recognised as being beneficial for consumers; both in terms of keeping costs down and incentivising investment where it can lead to improvements in service levels. For example, in RIIO-ED1 our customer satisfaction scores have continuously improved, our average distribution costs per customer have remained the lowest of all DNOs, and the number of power cuts and their length have also reduced over the same period.

Many of the RIIO benefits in electricity distribution have been enabled by Ofgem's ability to use comparative information across the 14 distribution companies to set targets and efficient allowances. Whilst we recognise that Ofgem does not have the same number of comparators in transmission and is therefore looking at new approaches to opening up competition in this sector; this should not involve a move away from incentive-based regulation that we believe is serving consumers well.

With regards to the SPV Model we have concerns that Ofgem has not yet fully considered the wider impacts on consumers from adopting this approach; in particular we are unconvinced that enough attention has been given to the allocation of risk with regards to the construction phase, as well as the operation of assets post construction. For example, the licensee will be expected to deliver a project on time in the same way that it is now, although it is unclear whether they will have the same risk reward balance; and if this is not the same whether this will translate into greater delivery risks. We also have reservations with regard to the strength of evidence Ofgem has provided on the benefits case of the SPV Model. Therefore, we believe more work is required to justify moving towards the implementation phase. Due to the additional risks and complexity associated with the SPV Model, it is uncertain whether these will be justified by any lower project costs borne by consumers. Whilst there are legitimate reasons for driving competition to reveal potential cost savings, Ofgem should ensure they review whether the SPV Model has worked as intended at pre-agreed checkpoints e.g. every 3-years from policy commencement. This review should conclude whether continuing competition under this model is appropriate for both existing and future consumers.

The following summarises our feedback on the SPV Model that Ofgem has presented:

- **There is a lack of clarity on how new SPV arrangements will enable DNOs to provide the necessary infrastructure and services that will underpin delivery**

  Currently DNOs have an established framework through price control arrangements to support TOs in delivering the distribution elements of their projects. When projects are tendered through the SPV Model it is unclear how distribution elements will be delivered. For this reason it will be important that DNOs are consulted and involved early in the tender process. Regardless of who the delivery body is, the associated licence will need to be explicit that none of the project's risks are transferred onto DNOs or their customers through DUoS charges. In addition, we may also insist that operational control of any new distribution assets are handed over to the DNO as currently happens. To this end we are unconvinced with Ofgem's assertion in its Impact Assessment that there will be no material cost to DNOs at the transmission and distribution interface from the SPV Model. Each project is bespoke in nature and will need to be assessed on a case-by-case basis. It is therefore important that any bidder, as well as the TO, fully understands the DNO's requirements and appropriately engages.

- **Ofgem has not fully considered the significance of changing the life-time of new assets and how costs will be recovered**

  Ofgem's RIIO-1 strategy decision justified the capitalisation of network assets over a 45-year basis and reflected Ofgem's desire "to shift the sectors onto a long-term sustainable path of inter-generational equity and fairness"[1]. The suggestion that new transmission assets should be treated on a 25-year basis would represent a significant departure from the existing RIIO-1 arrangements and calls into question whether Ofgem intend to apply this change across all RIIO-2 controls. Given the inter-generational issues it raises, we believe this proposal needs to be fully consulted on, with the benefits of the change and any drawbacks fully identified and costed. We recommend a full regulatory impact assessment is undertaken and that this is aligned with any RIIO-2 proposals for regulatory consistency.

  Whilst Ofgem has asserted that 25-year SPVs should result in a lower project WACC, it has not given any consideration into the impact this will have on consumers' bills. We are also unclear on how any handover of the asset to the TO would take place after the 25-year period. As the regulatory asset value at this point is zero there appears to be no incentive on either the TO or the SPV to build and maintain an asset to its optimal end of life. This issue arises because the RAV depreciation period would no longer correlate with the asset's technical depreciation period. With less incentive for transmission assets to be run optimally we are concerned that there could be knock on impacts to DNOs' customers with regards to network performance.

[1] https://www.ofgem.gov.uk/ofgem-publications/53838/t1decisionfinance.pdf

- **Without the statutory duties of a network operator there is a risk that SPVs will not meet the same standards, nor will they be exposed to the same level of governance**

  A key plank of the RIIO framework is that network operators are incentivised to take efficient decisions under the totex model, enabling outputs to be delivered at lowest cost for the benefit of both consumers and shareholders. We are concerned that the SPV Model moves away from this framework by giving key responsibilities to an unlicensed party and we are not aware of precedents for this. In the consultation document Ofgem highlights the learnings from the Thames Tideway Tunnel, PFI schemes and OFTOs, however each of these are different to the proposed SPV Model. Furthermore, the government recently announced that it will no longer support PFI schemes as they do not provide taxpayers value for money. Therefore, whilst there is potentially merit in allowing third parties to take a greater role in project delivery and finance, careful attention is required to how risks are allocated between network operators, the SPV and consumers.

  It also unclear whether, under the proposed SPV Model, a strong incentive for TOs to improve their performance remains. Under these new arrangements TOs would be akin to the System Operator, in that they would primarily become procurers of services, rather than network companies mainly focussed on asset stewardship. This would lead to a major policy change and is at odds with the RIIO-2 framework decision published by Ofgem earlier this year.

  We believe clarity on the boundary of asset ownership and regulatory responsibilities is a key issue to be resolved in the SPV Model. For example, there could be significant consequences if an unlicensed, third party led, SPV is unable to take on operational responsibilities such as outage management. As the incumbent TO is not the asset owner it is unclear whether they should be obliged to enter into agreements to take on such responsibilities. If they do agree to this, there may be significant costs associated with insurance liabilities, which have not been accounted for in the Ofgem consultation.

- **Ofgem's benchmarking of the costs and benefits of the SPV Model versus delivery by the TO appear to be over-simplified**

  Ofgem must further consider the drivers for their assumption that a third party SPV will categorically be more cost efficient than the incumbent TO. Whilst ring-fencing SPVs may encourage different financing arrangements that lead to a lower project-based WACC than previous TO price controls, it will lead to other risks and costs not captured in the project's WACC. We also believe by increasing the number of parties involved it will increase the complexity of project delivery; therefore this must be weighed up with the benefits case.

  In its impact assessment Ofgem is currently forecasting very low TO costs for running tenders in the SPV Model and helping to deliver any new assets onto the system (assuming it is not the TO that wins the bid). Due to the role TOs have in this process we would expect them to work with Ofgem to estimate these costs, however, this does not appear to be what Ofgem is proposing. If the costs associated with delivering an SPV Model i.e. administrative, legal, staff etc. prove to be significantly higher than Ofgem's current estimates then these will need to form an important part of the cost benefit analysis of implementing the SPV Model.

  A significant uncertainty when valuing the consumer benefits of an SPV Model are the operational costs and efficiencies. In its impact assessment Ofgem bases its benefits case on assumptions that the cost of debt and cost of equity applied for RIIO-2 will apply for the lifetime of the project. We believe this is a significant oversimplification, particularly as there is no precedent for the proposed operational arrangements.

We are concerned that the SPV Model may be steering towards more highly geared financing for the delivery of infrastructure, without full consideration of the consequences. Currently Ofgem sets a notional gearing factor in RIIO-T1 and RIIO-ED1 of 55-65% on the basis that this promotes a good quality of capital and financial resilience[2]. If, as expected, the SPV Model increases average gearing levels across the industry, this suggests a change in wider policy. However, we have not seen any evidence on whether this will be in the interests of consumers in the long term and therefore we believe this requires separate consultation, which takes a holistic view on the costs and benefits of any new approach. For example, in the water sector that has been pressure on network companies to reduce their gearing levels to more sustainable levels.

- **By excluding TOs from bidding in to a tender Ofgem is limiting competition instead of enhancing it**

  Whilst we acknowledge Ofgem’s position on managing conflicts of interest we cannot see the rationale for preventing TOs from being able to deliver projects, either directly or through a consortium, if they are the most competitive party to do so. If Ofgem do proceed on the basis that TOs are leading the tender and can bid in, then evidently Ofgem and Government should have assurances from the TO that they are neutral. For example, as part of our recent Flexibility Roadmap publication we have committed to providing independent assurance that the methodology we are using to market test is fair. If TOs are to become the lead procurer of new projects in the SPV Model, we also request clarity from Ofgem on what role the ESO has in this process, particularly as there would now be two parties possibly assessing solutions and a third party delivering the solution.

- **Any new approach must allow whole systems solutions to come forward as well as appropriately managing policy and commercial uncertainty**

  As stated in our response to the RIIO-2 framework consultation[3] Ofgem should evolve arrangements to encourage solutions that are optimal from a whole systems perspective. For example, we have already identified distribution-led interventions that can defer the need for investment at the transmission level. It is therefore crucial that in developing new approaches to competition Ofgem creates a level playing field between transmission and distribution options, as this will lead to consumer savings.

  In previous publications Ofgem highlighted Shetland as an example where a competitive solution has been successfully tendered by a network operator, in this case SSEN, for a lower cost than the counterfactual. However, since then Ofgem has changed its decision on the basis of two developments that were independent and driven by EU and UK government policy decisions. This serves to highlight the uncertainty associated with new tenders in terms of their needs and benefits case.

  For those bidding in, this uncertainty is very likely to increase their project WACC as there is no guarantee they will be able to deliver or fully recover the costs involved in bidding. Further, for consumers this could lead to increased costs if they have to fund projects that are not

[2] https://www.ofgem.gov.uk/ofgem-publications/91564/riio-ed1finaldeterminationoverview.pdf
[3] http://library.ukpowernetworks.co.uk/library/en/RIIO2/Main_Business_Plan_Documents_and_Annexes/UK%20Power%20Networks%20RIIO-2%20Framework%20response%20v1.1%20DP%202018-05-02.pdf

required. Whilst similar uncertainties exist in the RIIO price control arrangements, uncertainty mechanisms and the totex framework can limit any negative impact on consumers and investor confidence. In contrast the SPV Model may not provide as much flexibility.

If you wish to understand any part of the response in further detail, or indeed wider issues, myself, or members of my team would be happy to discuss.

Yours sincerely

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