

The introduction of the Competitively Appointed Transmission Owner (CATO)



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Background

Ofgem has committed to extend the use of competitive tendering to onshore transmission assets within GB following the conclusion of its Integrated Transmission Planning and Regulation project. Until now competition has been restricted to offshore transmission assets. The proposals could generate significant interest within the infrastructure investment market, given the potential for long term regulated revenue streams and other similarities to the offshore transmission owner regime.

Ofgem has also committed to enhancing the role of National Grid as system operator ("SO") meaning National Grid will have an increased mandate to identify and develop options to meet the needs of the onshore transmission system.

The changes to the SO role and introduction of a competitive tendering regime may affect developers of new generation projects seeking connection dates. The timing of competitive tenders for important reinforcements will be critical to many generation projects.

The introduction of competitive tendering is aimed at ensuring onshore transmission needs are met in an efficient and cost-effective way and is not driven specifically by a need to connect new generation more efficiently or quickly. New transmission assets tendered in this way will, it is proposed, be owned and maintained by CATOs.

Ofgem has launched a consultation, dated 19 October 2015 (the "Consultation") seeking views on its proposals. These proposals include: (i) the type of projects likely to be subject to tendering; (ii) the suggested tender models; (iii) the revenue payable to CATOs; (iv) the regulation of CATOs; and (v) how potential conflicts of interest arising

as a result of this new regime can be managed in the context of NGET, the SO and the incumbent transmission owners ("TOs").

A summary of the key proposals detailed in the Consultation is set out below. As a firm we are particularly interested in whether prospective participants in the market see managing the development phase (early CATO build) as a significant opportunity or as adding unacceptable risk, and whether the conclusion that RIIO-T1 projects are too far advanced by TOs to offer on an early CATO basis is justified.

What projects will be eligible for competitive tendering?

Onshore transmission projects which are "new, separable and high value" will be eligible for competitive tendering. The criteria which must be met include:

- expected capital expenditure of £100m or more;
- brand new or complete replacement transmission projects such as a new overhead line or substation;
- it must be possible to establish ownership boundaries of the assets forming the project however there is no requirement for electrical separation (e.g. via a circuit breaker); and



- the project must form an overall coherent package, however there is no requirement for the constituent assets to be physically connected to one another.

During the RIIO-T1 transmission price control period (2013-2021), Ofgem anticipates that only RIIO-T1 strategic wider works (“SWW”) projects will be eligible for competitive tendering. Ofgem is considering which of the SWW projects proposed by the TOs are suitable for competitive tendering.

From the start of RIIO-T2 and beyond (i.e. 2021 onwards), Ofgem anticipates that any new, separable and high value onshore transmission assets will be eligible for competitive tendering which may include transmission infrastructure required for generator connections. Ofgem anticipates that the SO will be responsible for identifying these tender projects based on the needs of the transmission system through a network options assessment. Ofgem will ultimately make the final decision, based on the SO’s analysis, as to whether a tender should be held for a project.

Tender models

The CRA has also amended the way that consumer and business disputes are to be dealt with. The following are the two key changes that the CRA has brought into play:

Ofgem have proposed two tender models: (i) early CATO build; and (ii) late CATO build.

Under the early CATO build model the CATO is responsible for all necessary preliminary works including consenting, surveys, and initial high level asset design. The CATO will also be responsible for construction and operation of the assets. Under the early CATO build model the tender would be held around 7 to 9 years before expected commissioning of the assets. Ofgem recognise that there is a large degree of uncertainty as to how project costs might develop and so Ofgem proposes a re-opener mechanism for additional costs efficiently incurred as a result of, for example, adverse developments in the planning process.

Under the late CATO build model the SO (or the TO for RIIO-T1 SWW projects) is responsible for all necessary preliminary works and the CATO’s responsibilities relate to detailed design, supplier engagement, procurement, construction and operation only. It is anticipated that under the late CATO build model the tender would be held around 4 to 5 years before expected commissioning of the assets.

In the short to medium term, where only RIIO-T1 SWW projects are likely to be tendered, Ofgem anticipates that the late CATO build model will be most appropriate, as incumbent TOs will already have carried out significant preliminary works.

A CATO of last resort mechanism will be introduced to mitigate the risk of project failure or CATO insolvency.

If a CATO was unable to continue its obligations during construction or operations, or a CATO is not appointed following the conclusion of a tender, it is proposed that a CATO of last resort could be appointed to step in to carry out the necessary works. In the event of a CATO failure, that CATO’s assets would be transferred to an appropriate existing CATO or TO (for a period of up to 5 years), following a direction from Ofgem.

Revenue and regulation (the CATO market offering)

Ofgem propose a core package of regulated revenue for a CATO as follows:

- a fixed annual revenue stream for construction and operation of the assets for a period of 25 years, with no periodic review;
- partial depreciation of assets over the 25 year revenue term to mirror the cost recovery period of 45 years under RIIO;
- a percentage proportion of revenue to be index linked to inflation with the CATO proposing the percentage in their tender bid;
- refinancing gain share mechanism to pass benefits of any lower cost of debt financing achieved during the 25 year period to consumers; and
- a mechanism to allow CATOs to make additional investment in their assets for upgrades and extensions during the 25 year term.

There will be incentives aimed at ensuring effective and efficient delivery of assets. To encourage system reliability, Ofgem are considering an availability-based performance incentive and penalties for energy not supplied to customers. The proposal is that the CATO’s exposure to revenue risk due to underperformance is capped at 10% of its annual revenue.

To encourage asset delivery, Ofgem consider that revenue should only start on asset delivery i.e. when the assets are available for use. In exceptional circumstances, such as where assets have a long construction period, revenue tied to the achievement of interim milestones may be considered.

The SO and incumbent TOs

Ofgem are mindful of ensuring a level playing field for all potential CATOs. The precise nature of managing any actual or perceived conflicts of interest arising from National Grid’s role as SO or the participation of incumbent TOs in competitive tenders has not yet been set out.



Given the enhanced role of the SO in identifying transmission projects and carrying out preliminary works under the late CATO build model, Ofgem anticipate that if National Grid seeks to participate in competitive tenders it will need to do so through a business which is sufficiently separated from the SO.

Ofgem also anticipate that the participation of incumbent TOs will have to be managed. TOs will also be able to participate in the competitive tenders, however Ofgem highlight potential conflicts of interests and the need to ensure there is no cross-subsidy under the RIIO price control regime or unfair treatment of CATOs where they wish to connect to the networks of incumbent TOs or use their preliminary works.

Ofgem seek views on how best to achieve a level playing field and mitigate potential conflicts.

Next steps

The Consultation closes on 11 January 2016. Ofgem state that they are working with the Government to draft legislation, but the timescales for such draft legislation are not yet clear. Ofgem intend, however, that further consultation will be undertaken in 2016 and expect that the first competitive tender will take place in 2017.

For further information on the introduction of onshore tenders and for assistance in responding to and understanding the impact of the consultation on your business please contact Patricia Hawthorn, Partner or Liz McRobb, Partner.

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