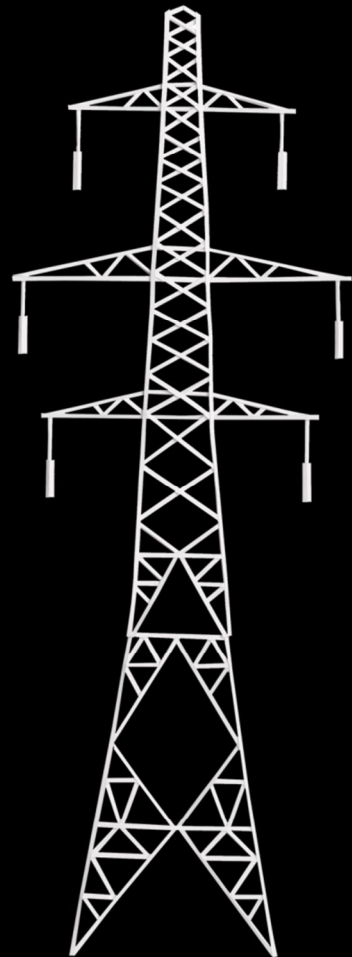

CATOs

Opportunities in onshore transmission



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CATOs

Opportunities in onshore transmission

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CATOs – opportunities in onshore transmission

The Opportunity

Ofgem has proposed to introduce competitive tendering to new, high value, separable onshore electricity transmission assets with the first CATO tender expected to be run by Ofgem in 2017.

Only strategic wider works (large investment projects that are not part of the price control settlement funding) will be included up to 31 March 2021 ("**SWW**").

Competitively Appointed Transmission Owners ("**CATOs**") will receive a 25-year fixed revenue stream subject to certain incentives and adjustments to construct, own and operate and, in the long-term, design transmission projects.

Ofgem has run a series of consultations on CATOs since October 2015 and is currently consulting on the criteria and process for identifying when a competitive tender can be run, the pre-tender arrangements, as well as conflict mitigation measures¹ (the "**Consultation**"). The Consultation closes on 22 July 2016.

Ofgem's informal estimate of the potential size of the competitive investment in respect of CATOs is one billion pounds (£1,000,000,000) to one billion five hundred million pounds (£1,500,000,000) of projects per annum during the period however the opportunity is widely anticipated to eclipse Offshore Transmission Owner (**OFTO**) investment currently two billion nine hundred and forty million pounds (£2,940,000)².

Background

Great Britain's onshore electricity transmission network is currently planned, constructed, owned and operated by three monopoly

transmission owners ("**TOs**"): National Grid Electricity Transmission ("**NGET**") in England and Wales, SP Transmission in the south of Scotland, and Scottish Hydro Electric Transmission in the north of Scotland. NGET is also the system operator ("**SO**") for the whole of GB's onshore and offshore transmission network.

These networks are natural monopolies and therefore Ofgem sets price controls that allow the recovery of a reasonable return on investment in addition to the companies' costs, provided the TO's achieve the targets set by Ofgem. The onshore TOs are currently regulated under the RIIO (Revenue=Incentives + Innovation + Outputs) - T1 regime.

However, in March 2011 Ofgem introduced competition in the offshore transmission sector by putting in place the OFTO regime. An independent report commissioned by Ofgem (in August 2014) found that the OFTOs had generated savings of two hundred million pounds (£200,000,000) to four hundred million pounds (£400,000,000) (against one billion one hundred million pounds (£1,100,000,000) worth of investment) across the first nine projects against the counterfactual price-control regime (the alternative policy options which Ofgem may have been expected to implement in the absence of the adopted OFTO policy)³.

Following the success of the OFTO regime in generating savings, Ofgem conducted its Integrated Transmission Planning and Regulation (**ITPR**) project in September 2015, and set out its decision to extend the role of competitive tendering to new, separable and high value onshore transmission assets.

¹ https://www.ofgem.gov.uk/system/files/docs/2016/05/ecit_may_2016_consultation_0.pdf

² Data includes projects awarded in R1 to R4 OFTO

³ <https://www.ofgem.gov.uk/ofgem-publications/87717/cepabdtr1benefitsassessmentfinalreport.pdf>



CATOs – opportunities in onshore transmission

Eligibility

Projects Defined

Onshore transmission projects that are new, separable and high value will be eligible for competitive tendering. A project is defined by Ofgem in the Consultation document as *an efficient package of works, or multiple packages of work to be delivered together which have been identified to meet a common need on the transmission system*⁴ ("Project").

New, Separable and High Value

New- To be eligible, a transmission Project must be new - this would include installation of brand new overhead lines, cables and sub-stations, as well as the complete replacement of existing lines, cables and sub-stations.

Separable- The Project must be separable from the existing transmission network. Ofgem proposals do not require electrical separability (for example, the use of a circuit breaker at each interface) in order for a Project to be eligible to be tendered. The assets also do not need to be directly and physically connected to each other in order to be tendered, however they must form part of a coherent package. Interface management issues are expected to be dealt with by way of commercial negotiation as they are dealt with under the current system. Nevertheless, under the proposals, the SO would be able to make a case for additional electrical separability, if it can show a cost-benefit justification based on system operability.

High Value- Ofgem intends to define high value as one hundred million pounds (£100,000,000) or above of capital expenditure ("**Capex**"). Ofgem believes that this level of value will ensure that the tendering benefits outweigh the tender costs and will attract competitive market interest from potential bidders.

⁴ Paragraph 2.31 of the Consultation document

During the RIIO-T1 period (2013-21)

Only SWW Projects will be eligible for competitive tendering during the RIIO-T1 period until 2021. SWW Projects are large projects identified by the SO for which funding has not been awarded to incumbent TOs as part of the price control settlement. Projects that are covered by price settlement funding are procured under EPC frameworks set up by NGET⁵.

The SO will be responsible for identifying SWW Projects (as well as developing the needs case – i.e. whether there is a technical and economic need for the SWW Project).

Once an SWW Project is approved, the relevant TOs will be funded to complete pre-construction works under the Early Build Model, a CATO will be appointed to undertake most of the Preliminary Works, which shall include initial solution design, surveys, environmental impact assessments, DCO and/or section 37 consents, easements, wayleaves, etc ("**Preliminary Works**").

Applications for construction funding will be submitted following completion of Preliminary Works - once the need and costs for the SWW Project have solidified. Ofgem is currently considering the suitability of the SWW Projects proposed by the TOs.

From the start of RIIO-T2 (post 2021)

Ofgem anticipates that all new assets that meet the eligibility criteria will be capable of being bid for CATOs from the start of RIIO –T2. The SO is expected to be responsible for identifying eligible 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.

⁵ The Onshore Underground Cable Framework and The Overhead Lines Design & Build Framework



CATOs – opportunities in onshore transmission

Paying for the CATO

Although Ofgem will determine the final market offering for a particular CATO nearer the time of the tender based on project specifics and the prevalent market conditions, the regulated revenue package and incentives proposed for a CATO are as follows:

Fixed 25-year revenue term

The CATO's annual revenue for the construction and operation of the assets will be fixed for a period of 25 years without any periodic reviews subject to limited reopeners for construction and operations risks which would not be economic and efficient for bidders to price into their bids. Such risks could potentially include foreign exchange rates, movement in base interest rates, unexpected ground conditions, extreme weather events and financing costs beyond the commitment periods.

It is expected that this will allow other costs to be fixed and for bidders to access a broad range of financing options as well as provide scope for financial innovation. For very large assets or those with a very long construction timetable, an exception may be made to allow partial revenue generation.

Construction risk is an inherent part of the structure as the annual revenue will only commence upon completion of construction to incentivise timely asset delivery.

A proportion of revenue (to be proposed by the bidder in percentage terms) will be index linked to inflation.

Residual Value and Impact of Financing

Consumers will pay for all the CATOs assets over the 45 year period (consistent with the period for cost recovery under the RIIO price control).

The difference between the period of cost recovery from consumers and the 25-year fixed revenue term, will mean that the CATO's asset will be allowed to partially depreciate over the 25-year fixed revenue term, leaving a residual asset value ("**RV**").

Ofgem has proposed that the CATO's asset will have a regulatory RV equal to the non-depreciated asset value, which is proposed to be set as a percentage of their bid Capex. This will then be recovered from future consumers.

This approach may require CATOs to use a bullet (or non-amortising) bond to finance part of construction, which could limit financing options and potentially drive up financing costs as a result. Ofgem also expects to clarify the regulatory treatment of RV in order to allow CATOs to secure debt finance for this portion of the costs and expects to make it subject to any deductions (capped at 10 per cent of annual revenue) based on clearly pre-agreed asset standards judged against clearly defined parameters contained in potentially the CATO licence.

Upon expiry of the 25-year fixed revenue stream, a CATO's assets may be dealt with by Ofgem in accordance with any of the following four options:

- Retendering and appointing a new CATO to take over the assets;
- Extending the CATO's revenue term for another fixed period;
- Transferring the assets to an incumbent TO or potentially another CATO at a price determined by Ofgem; or
- Decommissioning the assets in the event they are no longer required.
- Ofgem will decide the appropriate option route nearer the time on account of the fact that the transmission network is likely to change significantly over the next few decades.



CATO – opportunities in onshore transmission

Refinancing gain-share mechanism

The proposed refinancing gain-share mechanism will return a proportion of any refinancing gain during the 25 year period to consumers.

A loss sharing mechanism is not however envisaged, as Ofgem does not think that consumers should contribute to any refinancing losses incurred by a CATO.

Availability based incentive

An incentive based on meeting a percentage availability target may be offered (potentially with a capped upside and downside of annual revenue for over- or underperformance) to secure system reliability (similar to the position under OFTOs).

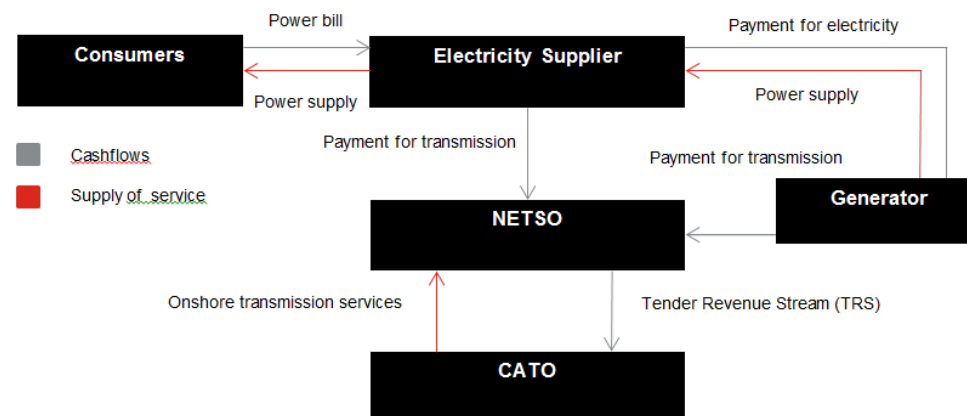
Ofgem proposes that up to 10 per cent of a CATO's annual revenue should be at risk through underperformance against the contractual availability threshold.

Other types of incentives

A mechanism to allow CATOs to make additional investments for upgrades and extensions during the 25-year term.

Incentives may be also be offered to ensure asset condition at the end of the revenue term – for example, by way of a performance bond or retention fund, whereby a certain portion of a CATO's revenue in the final year(s) could be made contingent on the assets meeting the required standard at the end of the revenue term.

Potential Payment and Service Arrangements for Onshore Transmission



CATOs – opportunities in onshore transmission

Tender Models

Ofgem has proposed to develop two CATO tender models - the "**Early Build Model**" and the "**Late Build Model**". The difference between the two is the stage at which the tender process is run.

Under the early Build Model, a CATO will be appointed to undertake most of the Preliminary Work whereas, under Late Build Model, the SO or TO would complete all necessary Preliminary Works and Ofgem would run a tender to appoint a CATO only for the construction and operation of the Project.

In the short to medium term, Ofgem will adopt the Late Build Model as RIIO-T1 SWW Projects are likely to be too far advanced for the first CATO tender to be procured under the early build model. Ofgem also believes that the Late Build Model is closer to existing public infrastructure procurement models and therefore would initially be more attractive to potential bidders.

The Early Build Model is expected to be used where the project design could benefit from competition.

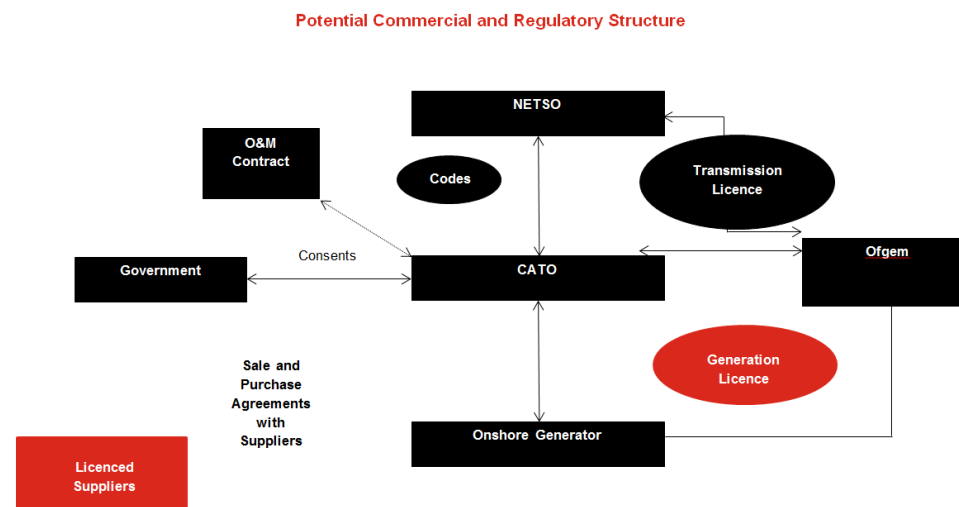
Ofgem has indicated that a Late Build Model tender will typically start around four to five years before the assets are needed, whereas the period would typically be around seven to nine years in the case of an Early Build Model.

Other main differences between the two models include:

Under the Late Build Model, bidders would bid a fixed price for construction and operation on the basis that they should have a high level of certainty over the Project and its output requirements⁶.

⁶ There may be some limited cost re-openers for risks during construction and operation that would mean that it would not be economic and efficient for a CATO to manage or for bidders to price into their bids at the tender stage.

under the Early Build Model, bidders would bid a fixed return on equity, a fixed gearing and an indicative cost of debt. This reflects the possibility that the Project scope may change during the Preliminary Works period.



NETSO will acquire land rights on behalf of the yet to be appointed CATO under the Late Build Model.



CATOs – opportunities in onshore transmission

Conflict Mitigation

Ofgem has proposed that the incumbent TOs be allowed to compete against third parties in the tender process to ensure a level playing field between the bidders.

This requires mechanisms to prevent conflicts of interest arising from the roles of the SO and existing TOs in relation to tendered Projects, or from other bidders with knowledge of a Project.

The measures for addressing conflicts of interest in respect of bidders other than SO and TOs mirror those that apply in case of the OFTO regime.

Ofgem highlights that there is more risk of conflicts of interest arising in the case of NGET given its role as SO and TO however conflict mitigation measures that apply in relation to SOs will be proposed in due course following Ofgem's wider work on the SO's role in relation to CATOs.

The Consultation document sets out Ofgem's proposals to address conflicts of interest arising from the following:

- the SO's role in relation to onshore competition;
- the TOs' roles in relation to onshore competition, in particular where a TO undertakes Preliminary Works for a tendered Project in RIIO-T1; and
- any other bidder with knowledge of a tendered Project.

Ofgem has proposed to address potential conflicts by placing the following key obligations:

obligations on conduct: to act transparently, efficiently and in a way that does not give the TO or any other party an undue advantage over other participants in the CATO tender process;

business separation measures: TO bidding party's access to the information should be the same as other participants, with clear division in management responsibility and restrictions on employee involvement, and physical financial, and legal separation between the TO Preliminary Works team and the TO bidding party; and

scrutiny: Ofgem has proposed that at a minimum, there should be internal scrutiny by a person appointed by the TO to oversee its compliance with the conflict mitigation measures and independent scrutiny should be considered.

Ofgem has proposed that a compliance methodology for approval should be submitted by TOs before a tender - which covers the steps the TO has taken in the three overarching areas of conduct, business separation and scrutiny and defines the relationship between the TO Preliminary Works team, the TO bidding party and any other relevant constituents of the TO. It should also include a compliance statement and an undertaking on arrangements that will apply during the tender.



CATOs – opportunities in onshore transmission

Timetable for Implementation

Identification of CATO Projects

Further information regarding the SWW programme and some of the Projects which may be taken forward under it can be found in [this](#) Ofgem factsheet.

It is not yet clear which SWW Projects may be taken forward by way of competitive tendering. Ofgem will decide whether to tender specific SWW Projects once it has considered submissions by the existing TOs in relation to the SWW Projects within their areas. In the medium to long term, the SO will be responsible for identifying Projects for tendering however, the final decision on tendering would lie with Ofgem.

Legislative Progress

On 21 January 2016, DECC published the draft primary legislation to be used to implement CATOs in its Draft Legislation on Energy (the "**Draft Legislation**").

On 3 May 2016 the House of Lords ("**HOL**") agreed in principle with the proposals to introduce competitive tendering for certain onshore transmission assets.

Draft clause 16 and the schedule to the Draft Legislation relate to competitive tendering for onshore transmission and distribution licences⁷.

⁷ The Government has proposed extending the competitive tendering regime to distribution networks as well, with a view to future proofing the Draft Legislation however this has been criticised by the Energy Networks Association for not being in consideration of potential implications although the Government has clarified that distribution assets will only be included in a competitive regime after due consultation and in any event only post 2023 upon completion of the current distribution price control period.

The proposed schedule amends the Electricity Act 1989, by inserting new section 6CA, which changes the provisions for recovering costs after a

tender exercise (currently in section 6D). It broadens the class of potential contributors to include those who had made a connection request in relation to a previous tender exercise, and to existing licence holders.

The HOL have made the following recommendations to the Government:

That the differential impact in Scotland compared with England and Wales be addressed to ensure a level playing field for transmission projects throughout Great Britain;

That Ofgem should have to publish a Project-specific impact assessment when it decides whether and how to tender an asset; and

That, the Government should set out how it will ensure the current planning regime in Scotland does not prevent or delay the development of competitively tendered Projects there.

Licence amendments

Ofgem intends to implement the revised roles and obligations on the SO and TOs in respect of CATOs by raising modifications to their licences following consultation. The modifications will cover the introduction of pre-tender arrangements and conflict mitigation measures.

Ofgem is expected to progress proposals for TO licence modifications as a priority following the Consultation (potentially summer 2016).

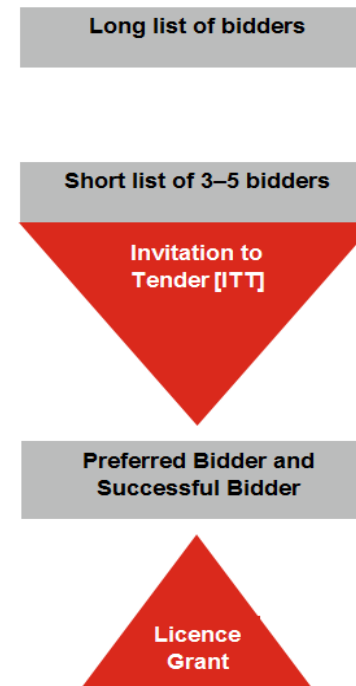
SO licence modifications to support onshore competition will be linked to Ofgem's wider work on the future SO role (detailed proposals for consultation are expected to be initiated next year with a view to implementation by late 2017 or early 2018).



CATOs – opportunities in onshore transmission

Potential CATO Appointment process

1. SO nominates Project and prepares the tender specification based on system performance requirements and Preliminary Works, including the parameters of any planning consent (in the case of an Early Build Model, the SO will prepare a tender specification setting out the system performance requirements and bidders will set out their high-level asset design and Development Consent Order (DCO) application, including detailed route planning).
2. Ofgem approves Project nominated by SO, and validates the Project scope and tender specification.
3. In case of a Late Build Model, the SO is funded to carry out Preliminary Works.
4. Ofgem runs a competitive process with defined tender stages and requirements which is accessible to range of funding approaches.
5. Project specific bidding opens based on a 25 year revenue stream.
6. Ofgem shortlists bidders based on evaluation of bidder's technical and financial capability and issues ITT to shortlisted bidders.
7. Ofgem evaluates tender offers against criteria covering capability/deliverability, costs and robustness of offer.
8. Preferred bidder is granted a licence and acquires a fixed 25 year revenue stream subject to application of incentives and adjustments, and complying with licence obligations.
9. Ofgem oversees the finalisation of arrangements between the preferred bidder and relevant TO to reach financial close



CATOs Team

For a further discussion of this note please contact the team below or your usual Nabarro partner.

Infrastructure, Construction and Energy



James Snape

Partner
T +44 (0)20 7524 6804
j.snape@nabarro.com



Lucy Plowright

Partner
T +44 (0)20 7524 6779
l.plowright@nabarro.com



Chris Hallam

Partner
T +44 (0)161 393 4757
c.hallam@nabarro.com



Aditi Tulpule

Associate
T +44 (0)20 7524 6364
a.tulpule@nabarro.com



Ryan Fordham

Senior Associate
T +44 (0)20 7524 6956
r.fordham@nabarro.com



Camilla Bolton

Associate
T +44 (0)20 7524 6467
c.bolton@nabarro.com



Priya Rawal

Associate
T +44 (0)20 7524 6365
p.rawal@nabarro.com

Real Estate and Planning



Martin Evans

Partner
T +44 (0)20 7524 6950
m.evans@nabarro.com



Joshua Risso Gill

Partner
T +44 (0)20 7524 6124
j.risso-gill@nabarro.com



Christopher Bowes

Associate
T +44 (0)114 279 4006
c.bowes@nabarro.com



Nabarro offices

London
125 London Wall
London EC2Y 5AL
T +44 (0)20 7524 6000

Sheffield
1 South Quay Victoria Quays
Sheffield S2 5SY
T +44 (0)114 279 4000

Manchester
1 The Avenue Spinningfields
Manchester M3 3AP
T +44 (0)161 393 4700

Brussels
209A Avenue Louise 1050 Brussels
Belgium
T +32 2 626 0740

Singapore
Marina Bay Financial Centre Tower 3
12 Marina Boulevard 35-01
Singapore 018982
T +65 6645 3280

Dubai
Office 105 Level 1
Tower 2 Al Fattan Currency House
DIFC PO Box 506873
Dubai United Arab Emirates
T +971 4302 6000

You can find out more about us at:
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