

Now That's What I Call CATO: Volume 1

As part of the government's wider review of the electricity transmission network (the Integrated Transmission Planning and Regulation (ITPR) project), and after its introduction of competition to offshore transmission assets and their owners (OFTOs), Ofgem has consulted on introducing competitive tenders for the design, build and operation of onshore transmission assets, thereby creating Competitively Appointed Transmission Owners (CATOs).

Introduction

Only assets considered strategic wider works (SWWs – large investment projects that are not part of the price control settlement funding) will be included in the RIIO-T1 period (up to 31 March 2021) with a wider scope anticipated for the price control period that follows.

Whilst CATOs are broadly expected to replicate the OFTO structure, a series of key questions remain as to the specific characteristics of CATOs. We will be discussing these in our series of introductory articles on CATOs. This, the first of the series, discusses the criteria that projects must meet to be considered for tendering.

In its consultation, Ofgem has suggested three criteria for SWWs to be capable of competitive tendering. Projects must be (1) **high value**, (2) **new**, and (3) **separable**. Below we examine the meaning of these terms and whether these criteria are likely to be appropriate to meet market appetite for investing in transmission assets.

High Value

'High value' means a project capital expenditure (capex) in excess of £100m. Whilst it appears that there is a preference for a threshold expressed in whole-life expenditure (totex), potential stakeholders also accept that capex is a reasonable proxy for totex and that the value threshold is a reasonable one.

However, questions remain as to whether this threshold is potentially too low. Some have argued that the transaction costs of smaller deals may significantly negate the consumer benefits. A higher threshold would deliver consumer value by decreasing relative transaction costs and concurrently reducing finance costs (as larger deals would be likely to attract more competitive financing tenders). Conversely, a smaller threshold value may increase competition as more investors would have the capability to bid for projects.

The Scottish system operators believe that the value threshold is too low and that their SWW thresholds (£50m and £100m in comparison to £500m in England & Wales) make their assets more likely to be subject to tendering. Whilst the government has announced that the minimum project value (as of November 2015) currently being considered is £500m, it left itself leeway to consider lower value projects (so watch this space). This said, the initial CATOs are likely to be high capital expenditure projects, thereby likely to benefit from relatively lower transaction costs and cheaper financing (with the large deal size potentially attracting interest from capital markets).

New

'New' means assets that are new (i.e. greenfield) assets or the entire replacement of existing assets. There had been some debate about allowing a de minimis level of existing assets to be included in projects, such that project assets would have to be 'substantially new'. (Arguments behind this including that it would simplify projects.) However, it seems that this qualification is likely to fall by the wayside and all project assets will be new. What may, however, continue to be a problematic issue is the issue of the transfer of existing assets into tendered projects and whether there will be a mechanism by which the incumbent transmission owner (TO) will be mandated to transfer assets to the CATO. Ofgem's response to the (recently closed) consultation may enlighten us as to the position regarding the transfer of assets.

Separable

'Separable' means ownership boundaries can be clearly delineated (and thereby responsibility accurately apportioned). It does not mean that assets must be electrically separable, for example by circuit breakers. This is a relatively uncontentious position and, whilst electrical separability is viewed as best practice, it will not be a prerequisite.

Looking Ahead

In view of these criteria, the key investor concern is for a clear pipeline of projects. Investors want to see multiple projects tendered such that if they miss out on one tender they will have opportunities on others. A sufficient number of projects will allow CATOs to be considered as a discrete asset and facilitate the development of both primary and secondary markets and greater liquidity. On establishing a clear pipeline, tender costs will fall and so may the minimum capex value threshold.

With the prevailing uncertainty in the global economy, infrastructure investment continues to offer an appealing regulated revenue stream. Further announcements from Ofgem are expected in the first half of 2016 (for projects tendering in 2017) and the number of tendered projects is likely to be a significant determinant as to whether CATOs can use this demand for safer, more predictable investments to generate sufficient investor interest and build a competitive and thereby ultimately successful market.

For further information, please contact



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