Commercial model update

Early competition

February 2024

ESO

Agenda

01. **Update on Early Competition progress**

02. **Update on key aspects of the commercial model**

i. Payment mechanism and Tender Revenue Stream
ii. Post-Preliminary Works Cost Assessment
iii. Security
iv. Preliminary works payments
v. Additional works
vi. End of revenue period

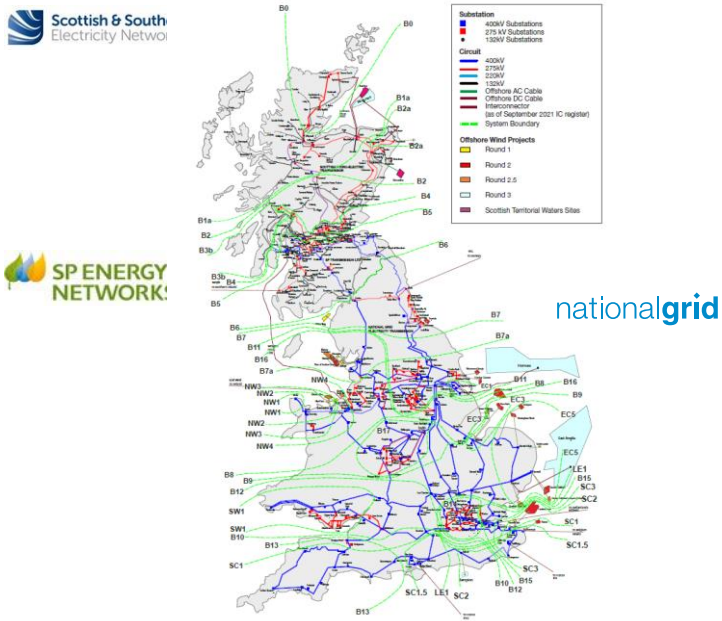
03. **Q&A**

We'd like to speak to you about early competition, please contact us at box.earlycompetition@nationalgrideso.com

Competition in onshore electricity transmission

The ESO has been asked by Ofgem to implement a model for Early Competition in onshore transmission

Existing transmission network



Introducing competition into onshore transmission…

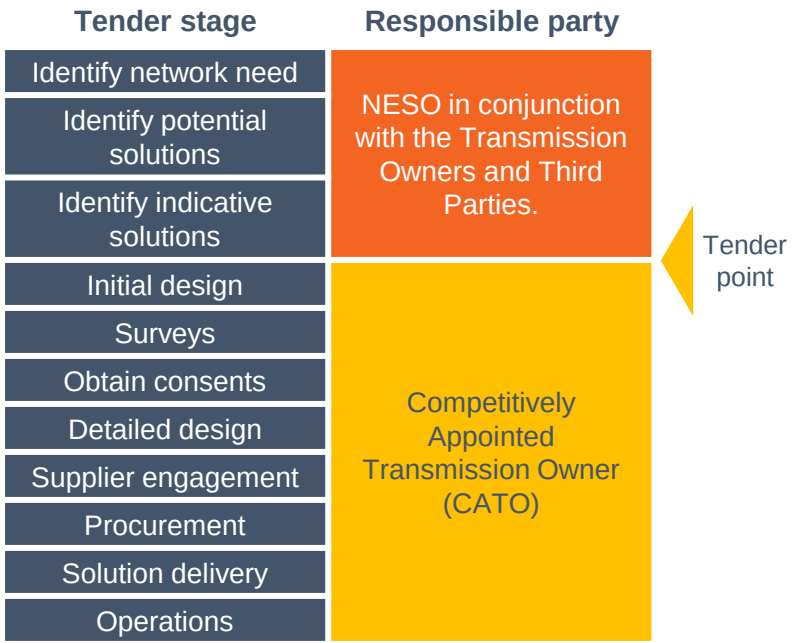
- **A competitive process to select the provider** of a solution to a specific need on GB's electricity transmission system
- **Selecting a solution provider at the 'early' stage**, before planning, consenting and detailed design (preliminary works)
- To the extent possible, **creating a level playing field** between alternative solutions
- **The ESO will transition to become the National Energy System Operator' (NESO)** - entirely separate from National Grid - and will become the procurement body for the competitive process

Source: NOA Refresh 2021-22

What is Early Competition?

Early competition is a competitive process to select a bidder, and a solution, to a specific need on the electricity transmission system.

Early Competition snapshot



Key highlights

- Organisations could **compete for the design, build, finance and ownership** of onshore transmission solutions.
- **Begins 'early'**, prior to the detailed design, surveying and consenting phases of solution development.

Potential benefits of Early Competition

Innovation

Cost savings

Strategic update

The early competition implementation update has been published and we are preparing for the launch of the first competition later in 2024.

March 2022

Ofgem ask the ESO the develop proposals outlined in Early Competition Plan to prepare for delivery.

August 2023

Winser Review recommendation to increase transmission infrastructure delivery

September 2023

ESO submitted and update on early competition to Ofgem

October 2023

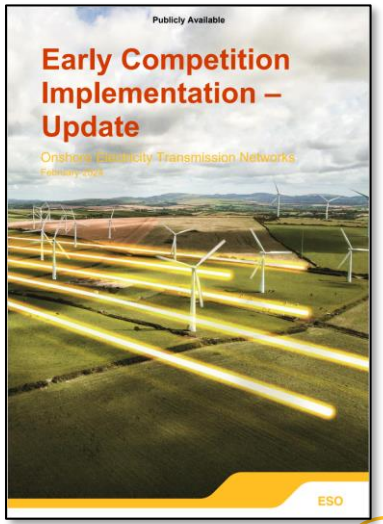
Royal Assent for Energy Act 2023

November 2023

Transmission Acceleration Action Plan confirms intention to start early competition in 2024

February 2024

Early Competition Implementation update published, available now on the ESO website.



Early competition implementation update

The implementation phase update explains how we have further refined the early competition model, including project identification, the tender process, commercial model, and delivery arrangements

The principal changes…

- The new Centralised Strategic Network Plan (CSNP) will identify the most appropriate solution type for a given need. Competitive routes will be tailored by solution type:
  - **Transmission solutions** will be competed through early competition and receive a licence from Ofgem.
  - **Non-transmission solutions** will be competed through the ESO's Network Services Procurement processes and contract with the ESO.
- **Revenue period:** An alternative basis for setting the length of the revenue period is proposed – a fixed term of 35 years.
- **Asset transfer:** Assets are assumed to be either re-tendered or discontinued at the end of the original revenue period.

To read more…

Scan to read the full early competition implementation update on the ESO website

Early Competition – Next Steps

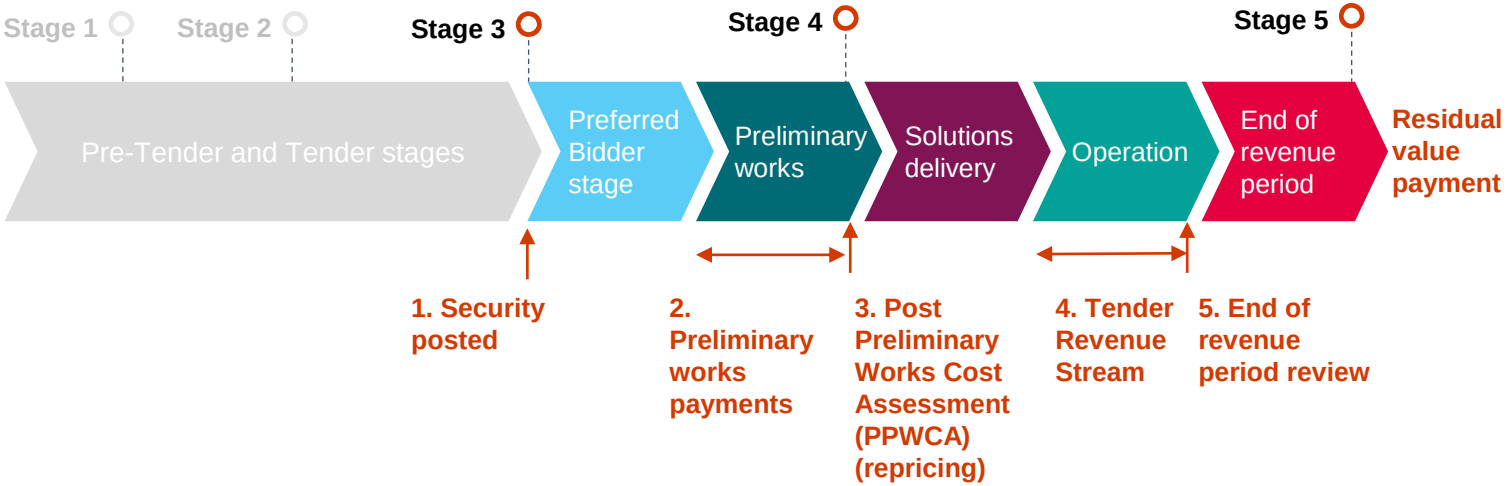
Now that we have set out our recommendations on the end-to-end process, Ofgem will consult on early competition and identify the first project later this year.

Recommendations to Ofgem	**Ofgem are now taking forward our recommendations:** • Consultation on policy areas and the CBA has been published • We anticipate that further consultation(s) on the tender regulations will come in due course
Project identification	• **The tCSNP is expected to be published in March 2024**, identify projects suitable for competition. • Later this year, **Ofgem will confirm the project(s) to be delivered through early competition.**
Commercial opportunity	• **Estimated average pipeline of >£1bn annually** – Ofgem's prior estimate of the pipeline of that may be suitable for competition over the course of the RIIO-2 price control period. • **Pre-tender expected to begin in December 2024** - We expect to initiate pre-tender work on the first project in December 2024 with tender launch in 2025

In the following slides we set out our current thinking. We would welcome your thoughts on these arrangements to identify areas for further development

The commercial model

Today's session will focus on the commercial model that will apply to the new CATO once the tender has concluded



Payment mechanism

Payment mechanism

The payment to a CATO during the operational period is based on the Tender Revenue Stream (TRS)

The TRS is an annual figure bid during the tender process and updated at Financial Close

The amount of TRS the CATO actually receives is subject to adjustment for:

Availability incentives

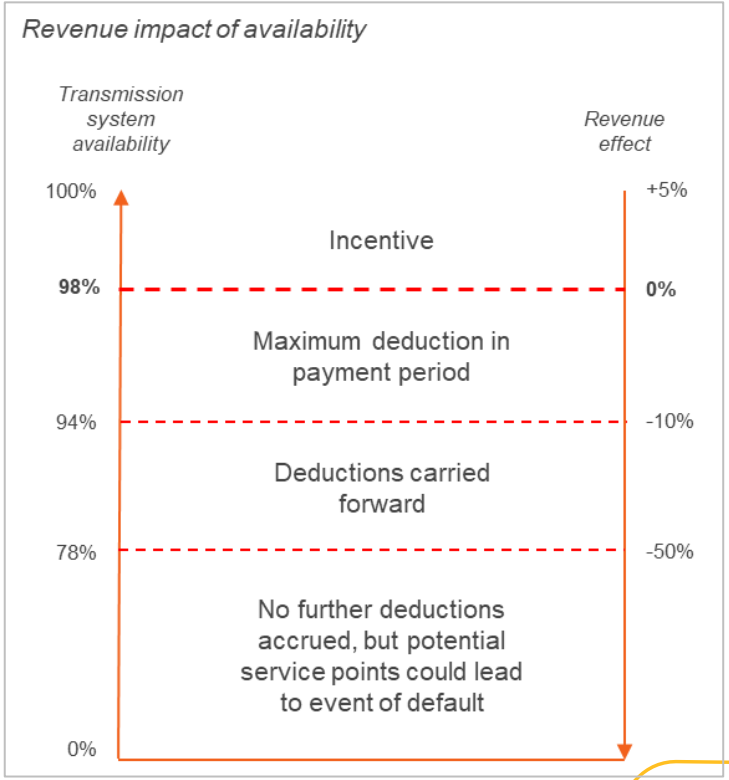
Partial indexation by CPIH

This approach is generally aligned to the **Offshore Transmission Owner (OFTO)** licence approach, with some alterations.

Payment mechanism – availability incentives

Availability will be measured using a similar mechanism to OFTOs.

- A CATO's assets will have a **baseline Maximum Transmission System Availability**, calculated as the Normal Capability Limit multiplied by hours in a year
- **Target availability is 98%** (in line with OFTOs), which means that performance deductions only impact the TRS when the total Energy Outages in an operating year exceed 2% of the Maximum Transmission System Availability
- **The potential performance deductions are capped at 10% per year**, with any **excess rolled forward to the next operation year**



Payment mechanism - indexation

The CATO's Tender Revenue Stream will be partially indexed

- The TRS Partial Indexation proportion will be **bid at ITT stage** and **set at Financial Close**
- These **inflation adjustments are applied on annual basis** for each Contact Year
- Adjustments will be based on **actual figures for the CPIH** published by the Office for National Statistics (ONS)

The TRS covers both:

- **Capital and financial costs** that may not be linked to inflation,
- **Operating expenses** that are subject to inflation

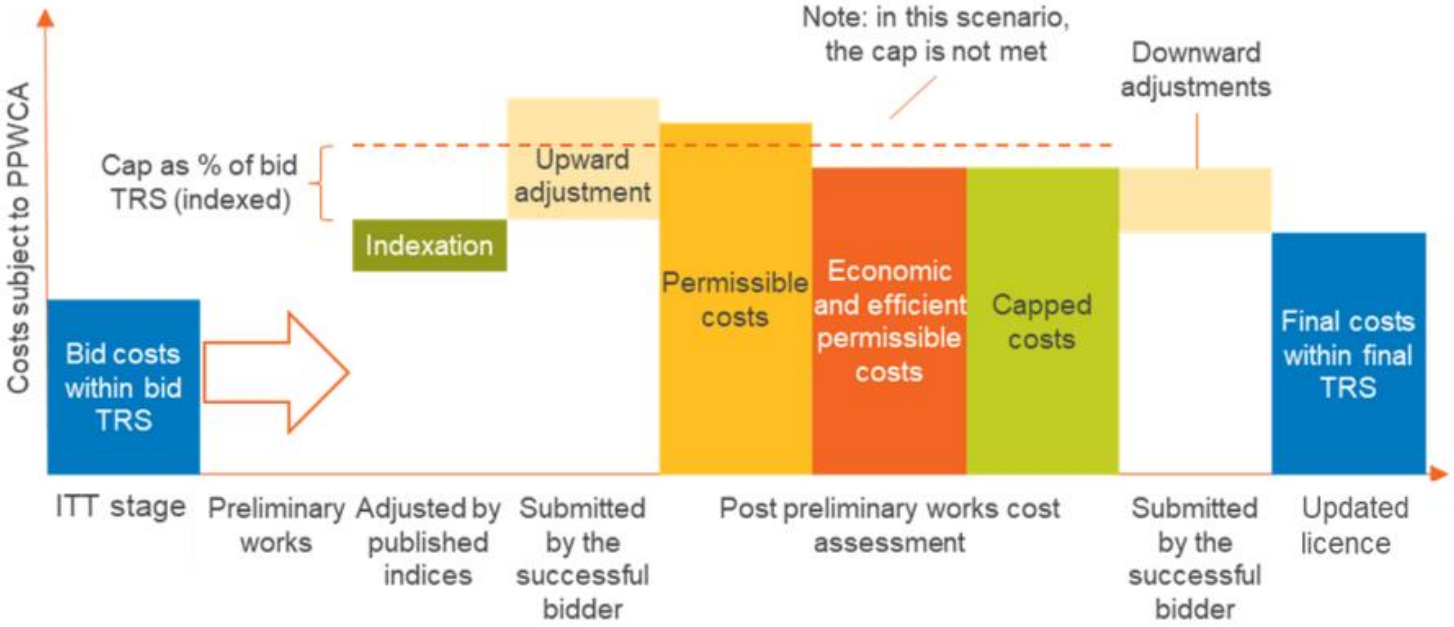
The TRS is inflated only partially set by reference to the Financial Model to achieve a "natural hedge".

This proportion is referred to as the TRS Partial Indexation.

PPWCA

PPWCA

The diagram below illustrates how the PPWCA would adjust costs bid at ITT stage to arrive at the final costs within the Tender Revenue Stream



Post-Preliminary Works Cost Assessment

A three-step PPWCA process, run by Ofgem, will consider changes in costs identified during the preliminary works phase

1. Was the cost change reasonably foreseeable at the time of the bid?
2. If it was not, and was therefore ‘reasonably unforeseeable’, is the cost economic and efficient?
3. Any permitted costs that are economic and efficient will be subject to a cap.

When final bids are submitted, underlying costs will be indicative only.

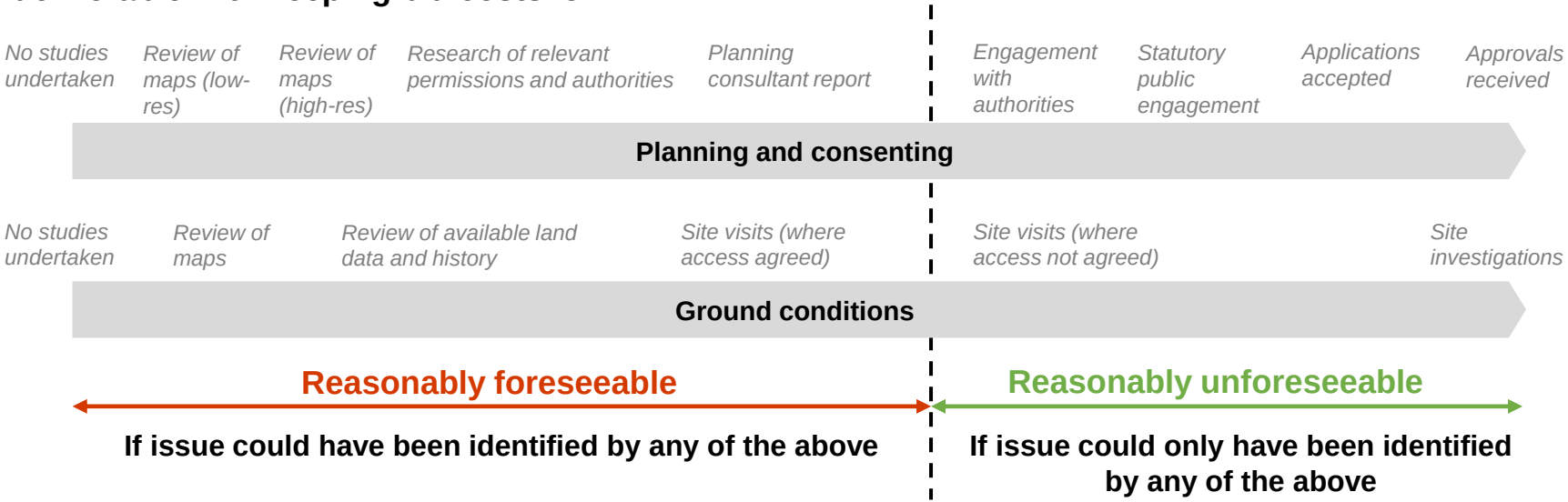
Under an Early Competition model, it may be 4-5 years from bid submission to construction start.

We recognise that contractors may be exposed to inflation risk during the preliminary works phase.

Therefore, **we are proposing to use various appropriate inflation indices to address inflation risk before the first step** in the PPWCA process.

Step 1: “reasonably foreseeable”

What is reasonably foreseeable would be set relative to the expected level of due diligence to be undertaken during the tender process – balancing the need for comfort that the solution is deliverable with keeping bid costs low



Guiding principle: Was the cost change for a reason which could not have reasonably been foreseen by a competent bidder following good industry practice?

Step 2: “economically & efficiently incurred”

Where a cost change is permissible, an 'economic and efficient' review would be undertaken on the cost (and so TRS) adjustment.

Ofgem will…

Look at the costs submitted at tender stage by the Successful Bidder (the competitive process setting the benchmark)

If there are no comparable costs, look at quotes received and market data (market benchmark)

Example consideration:

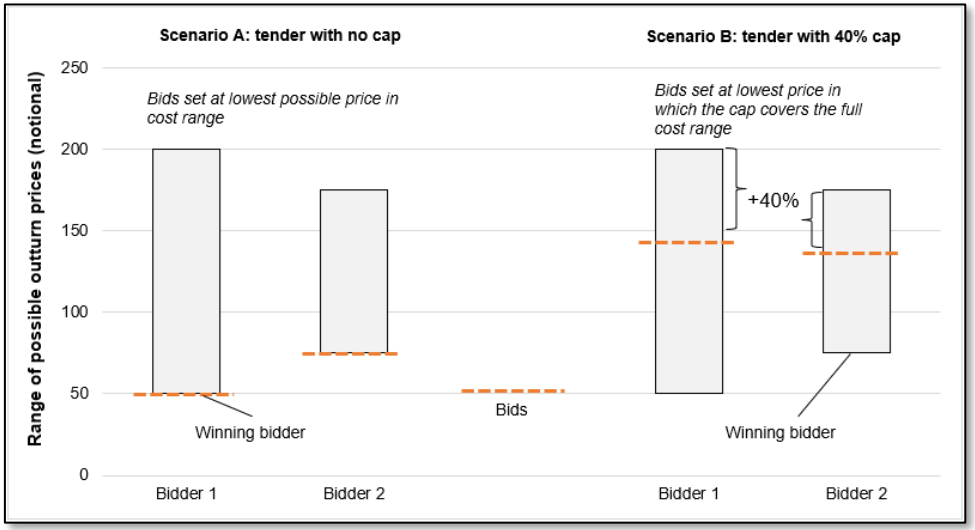
Can any of the cost be recovered from elsewhere such as through subcontractors or insurance, or was the cost impact reduced through any reasonable mitigating actions?

Ofgem has significant experience of conducting similar reviews through economic regulation, e.g. RIIO

Step 3: “Overall cap”

The tender process needs to be able to distinguish between a low priced (at the minimum expected outturn) but high risk (i.e. those whose range of outturn price is wider) bid, and a high priced but low risk bid.

- The cap plays an important role in incentivising bidders to assess the risk associated with their proposed solutions
- Without a cap, bidders are incentivised to bid the lowest credible price
- With a cap, bidders are incentivised to bid the price where the top of the estimated outturn range sits within the cap.



Any cumulative costs which exceed the set TRS adjustment cap (likely set as a % of bid TRS) will not be considered and so will not result in further upward adjustment to the TRS.

Downwards adjustments

After upward adjustments have been considered, the PPWCA process allows for downwards adjustments where savings from changes in design are available.

An incentive to identify savings:

- If the saving is identified by the CATO, the saving would be shared between the CATO and consumers
- However, if the saving is identified by Ofgem, the entire saving is for the benefit of the consumer

Example:

To manage risk, bidders may make conservative assumptions about route.

Should a lower cost route become viable and identified at PPWCA by the CATO, these savings are shared between consumers and the CATO

Security

Preliminary works and construction security

The successful bidder will have to provide acceptable security to guard against the risk of defaulting during the preliminary works and construction phases of the project

Acceptable types of security:

Performance bond

Letter of credit

Cash on deposit

Preliminary works

The level of security will be 10% of capex as set out in the successful bid, but this will be reviewed against the market during pre-tender

Construction

The level of the security will taper down to 0% until 10% capex has been invested by the CATO.

The counterparty will review this every 3 months to check how much the CATO has invested, then the security will be reduced accordingly.

Preliminary works payments

ESO

Preliminary works payments

There may be some revenue available for the preliminary works phase where the Procurement Body identifies this is beneficial to the process

- Value of payments will be set at the start of the tender
- Payment will be capped at 50% of the estimated preliminary works costs of the reference design
- Payments will be linked to achieving specified milestones (proposed by the bidder)
- Payments will be capped at the CATO's actual spend
- The amount paid will be deducted from the TRS during the PPWCA exercise

Relevant factors when considering whether to offer payments

1	Type and complexity of the project
2	Length of preliminary works phase
3	Market feedback

Setting the cap on preliminary works payments

In the pre-tender phase, an estimate of the preliminary works costs would be developed and used to set the cap on any payments.

Pre-tender phase

Procurement Body estimates costs and sets cap by reference to:

- Initially, experience from incumbent TOs for similar projects
- Later, experience from other early competition projects

Tender phase

Bidders propose:

- Preliminary works plan with milestones
- Allocation of cap to milestones

Milestones refined and agreed prior to licence award.

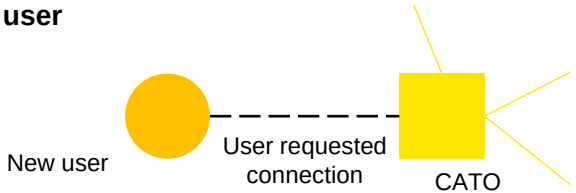
The procurement body will provide guidance as to the suitable stages of development for making preliminary works payments.

Additional works

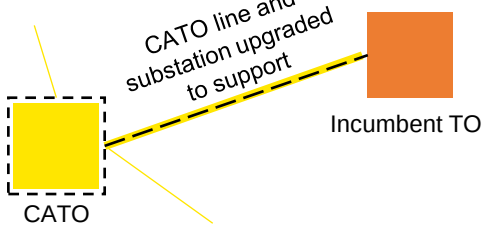
Additional works

It is proposed that the CATO will be obligated to support the development of the wider network during its operations period, to be in line with incumbent TOs

A. Indicative user connection



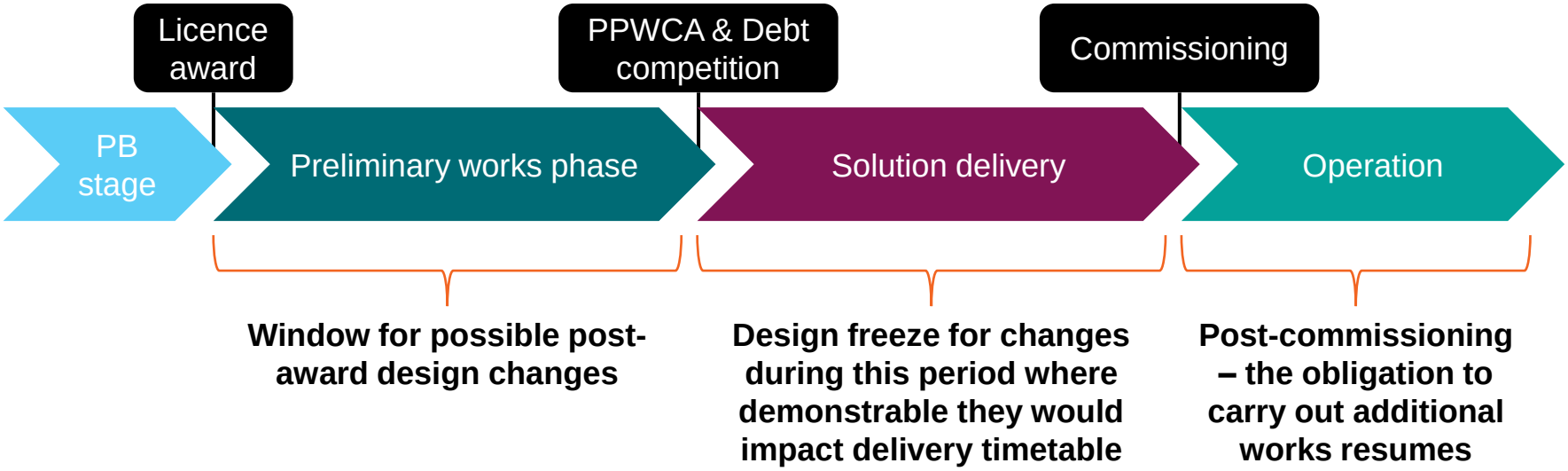
B. Indicative wider works



Additional works obligation	Provide offers to design, build and operate user connections to the CATO system	Modify CATO asset as a result of user connection elsewhere on the NETS	Modify CATO asset to support development of the wider network, following changes in another TOs Investment Plan	Modify CATO asset if network planning process shows this to most economic and efficient option
Source of obligation	Obligation borne out of TO licence (SLC D4A) with detail in STC Section D (Part 2)	CATO required to provide Affected TOCO to user under STCP 18.1	Obligation borne out of STC Section D Part 1 (Transmission Investment)	Obligation borne out of STC Section D Part 1 (Transmission Investment)

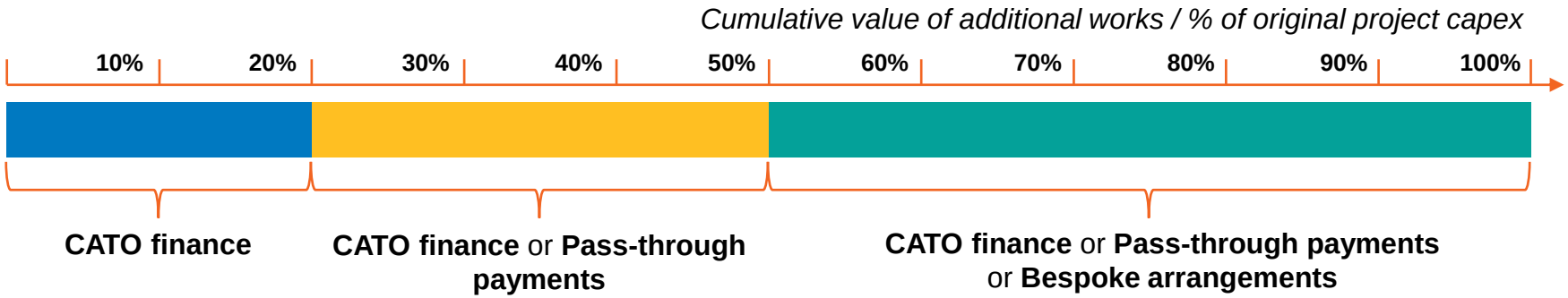
Additional works: Design freeze pre-construction

Although the CATO will be obligated to undertake additional works, this obligation will be frozen during delivery to avoid negative impacts on the timetable, where this can be demonstrated by the CATO.



Possible options for funding new investment

Depending upon the value of the additional works, different funding routes may be available



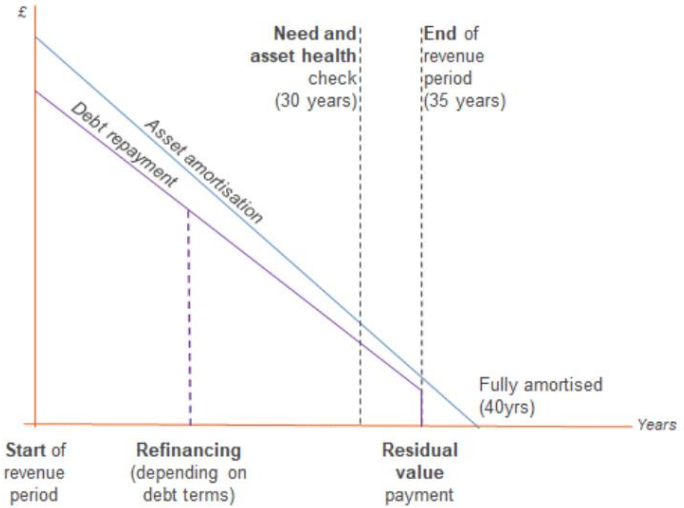
- CATO carries out design and costs the additional works
- Design and costs are assessed independently (Ofgem) to ensure the proposal delivers maximum value
- The decision from independent assessment is final
- The incentive is on the CATO to ensure the additional works carried within the determined cost level
- Pass-through payments impact TNUoS for user but are considered a relatively small proportion of annual TNUoS charges

This proposal is with Ofgem for decision

End of the revenue period

The revenue period

A 35-year fixed term revenue period is proposed. A review of asset need and health would be undertaken 30 years into the revenue period, determining the end of period arrangements:

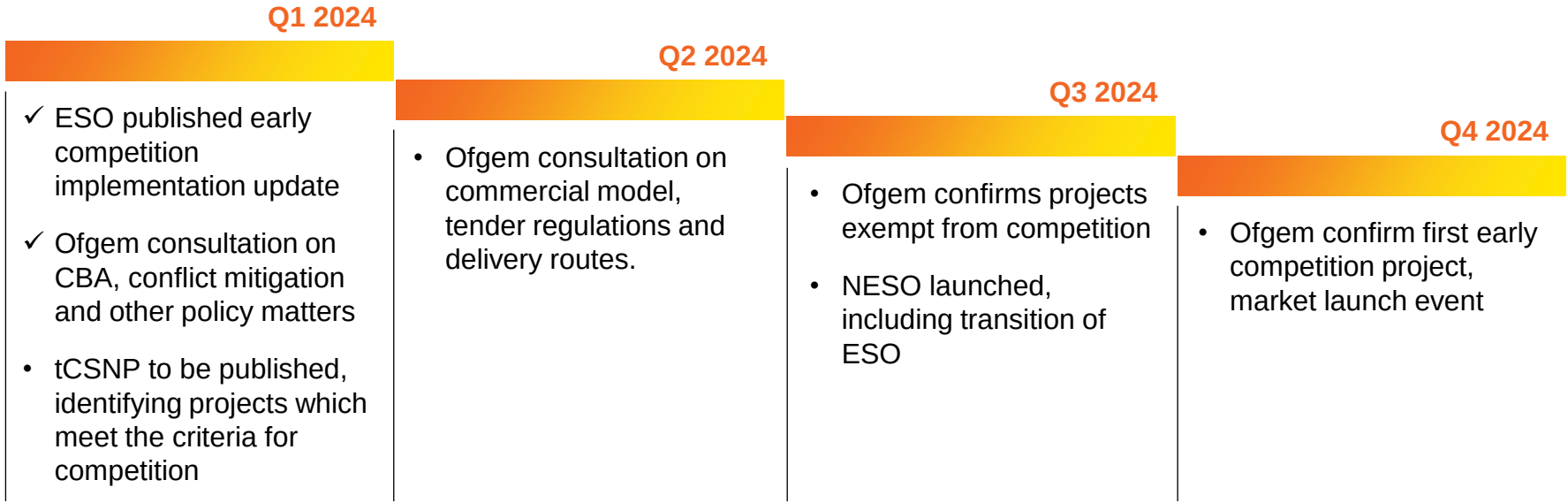


- If the need ends at year 35, decommissioning provisions would apply. The CATO would be paid the residual value from TNUoS.
- If the need ends between years 35-40, the revenue period would be extended, with no new investment but including a payment for operation and maintenance.
- Should the need extend beyond year 40, the project would be re-tendered. The existing asset would be transferred to the winning bidder for reinvestment.

Next steps

Next steps for early competition

Ofgem will consult on the commercial model in the first half of 2024. By the end of the year, the pre-tender phase for the first project will begin.



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Q&A