

## Insights

# THE WAIT FOR CATOS CONTINUES, BUT THE PICTURE MIGHT JUST BE GETTING CLEARER

Jul 28, 2025

As part of the government's wider review of the electricity transmission network via the Integrated Transmission Planning and Regulation Project, and after its successful introduction of competition to offshore transmission assets and their owners (**OFTOs**), Ofgem has continued to consult on introducing competitive tenders for the design, build and operation of onshore transmission assets, thereby creating Competitively Appointed Transmission Owners (**CATOs**). We have previously considered:

- the specific characteristics of CATOs
- the difference between the development models proposed by Ofgem in its consultation – “early”, “late” and “very late”
- the proposed revenue stream and incentives
- and Ofgem's work in 2024 on finalising an “early” model of competition.

In September 2024 we looked ahead, optimistically, to a busy Q4 for those with an interest in the commercial model, tender process and tender regulations for that competition. Progress has slowed, but this month Ofgem set out its final decisions and updated policy positions on the commercial framework that will govern how CATOs are selected and regulated to finance, build, operate, and maintain onshore electricity transmission assets in Great Britain. In this insight we summarise the key commercial takeaways from Ofgem's recent decision document.

## POST-AWARD SECURITY OBLIGATION

- CATOs must post security, following licence award, equal to 10% of forecast construction costs, capped at £50 million for projects up to £1bn in value.
- Security will remain in place during the preliminary works stage and construction stage and tapers to 0% once investment equivalent in value to that security has been made.

- Acceptable forms of security will include: performance bonds related to payment, not performance; (potentially conditional) letters of credit; or cash in escrow.

## **PRELIMINARY WORKS PAYMENTS**

- Ofgem has decided to allow the provision of “preliminary works payments” during early project stages to reduce equity risk and encourage participation.
- These payments will be capped at 50% of estimated costs, though Ofgem may exercise discretion with flexibility for early projects if market feedback ahead of the early tenders suggests this would be beneficial for the success of the tender and consumer interest.

## **POST PRELIMINARY WORKS COST ASSESSMENT (PPWCA)**

- The PPWCA allows for cost adjustments after a CATO has completed the preliminary works but before the main construction phase begins and is intended to respond to design modifications, inflationary pressures and other unforeseen changes that may affect project costs between the initial bid and the end of preliminary works.
- Although NESO had proposed a 40% cap on this adjustment, Ofgem has determined a cap higher than 40% will apply for the first tender to ensure a strong level of bids.
- High-impact, low-probability events such as force majeure are excluded from the cap to mitigate against inclusion of excessive risk premiums in bids for low-probability scope changes occurring.

## **PAYMENT MECHANISM & PERFORMANCE INCENTIVES**

- Ofgem has decided to accept the TRS model (familiar to those with an interest in OFTOs) and indexation of the TRS to CPI-H.
- Proposed incentives for availability will be set at a 98% target - again in line with OFTOs - with mechanisms for availability measurement, service reduction adjustments, first and last periods adjustment and seasonality adjustments.
- No financial penalties will accrue for late delivery against the target delivery date.
- Crucially, Ofgem agrees with NESO’s proposal of not mandating the equity gain share for early competition projects.

## **ADDITIONAL WORKS OBLIGATION**

- Ofgem has decided to accept NESO's proposal to include an additional works obligation - additional works on its assets over time, either to increase network capability or to facilitate new network connections - and will propose this for inclusion in the CATO licence.
- Ofgem proposes that funding arrangements for the additional works obligation should be as follows:
  - CATO to finance the cumulative level of investment up to 20% of the original CAPEX value (not indexed);
  - for additional works with a cumulative value greater than 20% and up to 50% of the original CAPEX value, CATO will have the option to either self-finance or take pass-through payment; and
  - for additional works with a cumulative value greater than 50% of the original CAPEX value, CATO can either opt to self-finance the obligation, receive upfront payment or agree a bespoke funding arrangement with Ofgem.

## REVENUE PERIOD

- Ofgem has settled on a "standard" 35-year TRS, with asset amortisation over 40 years and a residual value payment equal to  $5/40^{\text{th}}$  of the original asset value at the end of that period.
- Because the revenue term exceeds "standard" debt tenors, Ofgem will agree to a debt refinancing if the market feedback during the initial Debt Funding Competition (**DFC**) for a tender indicates:
  - no credible financing option which does not include a refinancing; or
  - NPV of the TRS calculated using a financing option with refinancing is significantly lower than without it
- An Agreed Refinancing (part of a CATO's initial DFC) will not be subject to the gain share provisions applied to other refinancings. Any positive or negative impact of Agreed Refinancing would be fully passed through to consumers. However, performance risk will be borne by the CATO.

## NEXT STEPS

Ofgem has committed to consult on the CATO licence later in 2025. At the same time, NESO is currently assessing projects from the Holistic Network Design Follow Up Exercise (following ongoing impact assessments and network re-design) for their suitability for competition and will then assess projects submitted into the tCSNP 2 Refresh, expected to be published in 2026, with a view to identifying a first and subsequent pipeline of future projects for onshore competition.

## **RELATED CAPABILITIES**

- Energy Transition
- ESG & Energy Transition
- Renewables & Storage

## MEET THE TEAM



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